

IN THE DISTRICT COURT OF THE UNITED STATES
DISTRICT OF SOUTH CAROLINA
CHARLESTON DIVISION

ROBERT J. NAGY,) 2:08-CV-2555
)
Plaintiff) Charleston,
) South Carolina
VS) June 21, 2010
)
UNITED STATES OF AMERICA,) VOLUME I
)
Defendant)

TRANSCRIPT OF JURY TRIAL
BEFORE THE HONORABLE DAVID C. NORTON,
CHIEF UNITED STATES DISTRICT JUDGE

APPEARANCES:

For the Defendant: MR. NATHAN CLUKEY
MR. GREGORY SEADOR
MS. ELLEN WEIS
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Proceedings recorded by mechanical shorthand,
Transcript produced by computer-aided transcription.

1 THE COURT: Okay. What do we need to do first? Do
2 you want me to put Mr. Debevc on the record and let him go
3 home?

4 MR. CLUKEY: Nathan Clukey for the United States.

5 Your Honor, on Sunday we had discussions with Mr.
6 Debevc; and ultimately, we wanted to put on the record that
7 Mr. Debevc agreed to an Entry of Judgment against him for the
8 full amount of the penalties that are at issue in this case,
9 \$3,353,633 assessed against him without admitting
10 liability -- I'm sorry -- without admitting or denying the
11 allegations in the Government's countersuit.

12 THE COURT: All right. Is that your understanding,
13 Mr. Debevc?

14 MR. DEBEVC: Yes, Your Honor, that is.

15 THE COURT: Goodbye. All right.

16 MR. CLUKEY: Your Honor, Mr. Debevc has been served
17 with a subpoena to testify tomorrow.

18 THE COURT: Okay. So you know how to get in touch
19 with each other?

20 MR. DEBEVC: I'm aware I have a subpoena and know
21 that I have to be here.

22 THE COURT: Okay. Thank you very much, Mr. Debevc.
23 What's next?

24 MR. CLUKEY: We've got the -- this issue of
25 conspiracy we would like to argue. But before we do that,

1 Your Honor, the Government would like to reraise its
2 objection to the no-change letter, given what has just
3 happened.

4 The fact that Yuri Debevc is out, we believe that
5 when you asked for an argument, one of the factors you may
6 have considered when allowing the no-change letter into
7 evidence is that Yuri Debevc was not a tax professional.

8 And as was discussed during the prior argument, the
9 fact that. Mr. Nagy is a tax professional, he is charged
10 with knowledge, under 26, USC, 6700, he's charged with
11 knowledge of tax laws. And we just would like to reraise
12 that in the event the fact that Mr. Debevc was in the case at
13 the time played any role in your decision.

14 THE COURT: All right. Those are the no-change
15 letters to Derivium and Scott Cathcart, Mr. Debevc?

16 MR. CLUKEY: Yes, Your Honor.

17 THE COURT: Yes, sir?

18 MR. COOPER: We would just maintain the same
19 arguments, that had an impact on his state of mind. Mr.
20 Altomose is going to talk about what they mean in the
21 industry practice of the tax professionals.

22 THE COURT: I don't know about that.

23 MR. COOPER: Well, I mean, certainly, when you go to
24 the IRS, the communications with the IRS that are relevant to
25 his state of mind.

1 Your Honor, may I pass up -- we wrote something
2 briefly on the conspiracy issue.

3 THE COURT: Sure.

4 (Pause in proceedings.)

5 THE COURT: All right. I'm ready on the conspiracy.

6 MR. CLUKEY: Ms. Weis is going to talk about the
7 conspiracy.

8 THE COURT: Sure.

9 MS. WEIS: Your Honor, we understand that Mr. Cooper
10 has handed you a brief that takes issue with the legal
11 standard saying that South Carolina state law, for what a
12 cause of action in a civil conspiracy applies, rather than
13 the federal cases applying Rule 801's definition of
14 conspiracy.

15 So I can address that, in addition to our general
16 arguments. And also, he takes issue with the factual
17 predicates of Mr. Nagy being a coconspirator under 801.

18 As we stated to the Court on Friday and mentioned to
19 the Court in oral argument, it's already been established
20 that the 90% Loan Program is a plan or arrangement under
21 Section 6700.

22 In other words, through the actions of a number of
23 individuals acting in concert towards the common goal of
24 profiting from the business venture of a 90% Loan Program,
25 that constitutes a conspiracy under Rule 801.

1 In addition, there has been several cases that we
2 cite in our brief, and I can provide another one, in which
3 801 has allowed coconspirator sections in circumstances that
4 are similar to what exists here.

5 For example, in *USF Red Star*, a Fourth Circuit case,
6 a civil case, the Court allowed coconspirator exceptions to
7 be admitted by statements that were made by company
8 management to be admitted against the union, where a union
9 representative had gotten company management to fire an
10 employee that he didn't like. Simply put: Those acts of
11 trying to fire an employee are sufficient to satisfy the
12 coconspirator exception in the Fourth Circuit.

13 In addition, relevance, which is an Eighth Circuit
14 case -- I can provide the citation to this, it's not
15 contained in our brief -- is a case in which there is a tax
16 scheme where an accountant and a company president are
17 working together through a tax scheme to lose tax loan
18 proceeds to hide income. And the Court, under the
19 coconspirator exception, said it was not an agent admission;
20 allowed the accountant statements to be used against the
21 company president.

22 Under *Nguyen*, a D.C. Circuit case from 2006, the
23 Court allowed statements made in connection with a pump and
24 dump fraudulent stock promotion scheme to be used against the
25 promoters.

1 And in *Renfrow*, a 2009 D.C. Circuit opinion, the
2 Court allowed statements by a realtor to use -- the
3 defendant's realtor -- to be used against the defendant.
4 Again, not under the agent only, but under the coconspirator
5 exception to a Rule 801, because the two were engaged in the
6 common goal of attempting to purchase or acquire, in that
7 case fraudulently, real estate property.

8 Now, factually, we believe that Mr. Nagy satisfies
9 the coconspirator exception, and we will need to look at the
10 exhibits that are already in evidence to provide a factual
11 predicate to allow Rule 801 to apply.

12 We know from Government Exhibit 210 that Mr. Nagy
13 became involved in 1997, the same year that the scheme began.
14 He signed a confidentiality agreement through Government
15 Exhibit 334, in which he "agreed to" "serve as backup to
16 Charles Cathcart." He considered Derivium Capital to be his
17 number one priority plan, as shown in Government Exhibit 200.
18 And he provided business services for many of the entities
19 involved in the scheme.

20 He sent, what we call a status update memo, to
21 Charles Cathcart in 2001 describing his -- what the work he
22 had been doing for all sorts of intents in regards to the 90%
23 Stock Loan Program. And he says -- this is a very good
24 example of how Mr. Nagy is a coconspirator under Rule 801,
25 which is Exhibit 147, "I would like to continue the

1 development of now offshore products."

2 This is not a short-term priority, but in the
3 long-term, it can be the most significant and lucrative area
4 for expansion of stock loan products.

5 As the Court is aware, Mr. Nagy also provided tax
6 advice to Derivium in the 90% Loan Program, and looking to
7 Government Exhibit 80, in his own words, Mr. Nagy knew, "The
8 bottom line is that Derivium cannot market a product that
9 does not work tax-wise."

10 In addition, these tax memos were substantively
11 edited by Charles Cathcart. Mr. Nagy would like to portray
12 himself an outside advisor who was ignorant of what was going
13 on.

14 Setting aside the coconspirator does not need to
15 know exactly everything that is happening in the conspiracy,
16 for 801 purposes, the fact that Charles Cathcart, as shown in
17 Exhibit 94, made substantive edits, further indicates that
18 Mr. Nagy was working with him towards the common goal of the
19 90% Loan Program.

20 Mr. Nagy, as we know, wanted to continue from the
21 90% Program even after Derivium closed its doors --
22 Government Exhibit 189 -- on Friday, and he was paid
23 extremely well for this work.

24 Government Exhibit 193 is a \$20,000 check from
25 Derivium Capital that Mr. Nagy applied to work he did for

1 Derivium, Yuri Debevc, Scott Cathcart, Charles Cathcart,
2 Shenandoah and Scienda.

3 Therefore, we would ask the Court to admit the
4 statements, the coconspirator statements, statements by
5 coconspirators of the 90% Program against Mr. Nagy under Rule
6 801.

7 We are not asking the Court to make a broad ruling
8 at this point that every single exhibit would come in; we
9 obviously agree that we need to still show the statements
10 were made during the course and in furtherance of the
11 conspiracy, but at this point, we believe that there is
12 sufficient evidence that Mr. Nagy is a coconspirator for the
13 Rules of Evidence purpose that this exception applies.

14 And when Mr. Cooper cites to the Court South
15 Carolina civil law, we would like to point out that we have
16 cited Fourth Circuit case law and District -- D.C. Circuit
17 case law, which do not indicate in any regard that state law
18 applies.

19 And in fact, the Fourth Circuit in a case which is
20 cited in our brief looks to criminal conspiracy, the
21 standards of agency principal law, to figure if a conspiracy
22 exists as a separate matter, and then applies that standard,
23 not state law, to decide that there is a conspiracy for the
24 purposes of Rule 801.

25 So under those principles, we believe that Rule

1 801(d)(2)(E), that they should apply to Mr. Nagy.

2 THE COURT: Would you give the cite of that Eighth
3 Circuit case?

4 MS. WEIS: It's *United States vs. Sullivan*, 985
5 F.2d, 962, Eighth Circuit, 1993.

6 THE COURT: Okay. Great. Thanks.

7 Yes, sir?

8 MR. COOPER: Your Honor, the conspiracy theory here
9 should not apply.

10 Mr. Nagy was an outside accountant giving tax
11 advice, and that was the focus of his participation. He also
12 did the tax returns for the other entities, and those were
13 his activities.

14 They are trying to apply this coconspiracy theory to
15 everything that was going on behind the scenes that Mr. Nagy
16 did not know about.

17 Now, when she talks about which law should apply,
18 she said they looked to the criminal statute of conspiracy
19 for that case; and in fact, the majority of their cases are
20 in the criminal context. This is not a criminal case.

21 So at that point, in implying what does conspiracy
22 mean in the federal law, a lot of times Federal Courts do
23 take state law to determine how to apply that federal
24 statute.

25 And we are saying here, if you look at civil

1 conspiracy under South Carolina law, his intent, and the
2 intent of when he was providing his advice, would have had to
3 have been to harm the IRS. We don't know how you could find
4 that intent of Mr. Nagy; when in fact, during the audits, he
5 disclosed the loan transaction to the very person that now
6 complains about it. He told them that the stock was sold.

7 So if any harm was caused by his advice of what they
8 were doing, it was because they didn't do anything for four
9 and a half years.

10 So there couldn't have been that intent to harm by
11 his very actions from 2001 to 2003. So we don't think there
12 is any intent to harm.

13 In addition, Mr. Nagy didn't take profits in this
14 scheme, just like us lawyers down here, we get paid by the
15 hour for our services. He wasn't a partner of Derivium; he
16 didn't get income from Derivium.

17 THE COURT: That's a little thin right there. He
18 got income from Derivium, right?

19 MR. COOPER: Well, he was paid hourly for his
20 services.

21 THE COURT: So he got income.

22 MR. COOPER: He didn't participate in profits.
23 Thank you, Your Honor.

24 THE COURT: All right.

25 MR. COOPER: And in addition, they have to show that

1 the statements were in furtherance of the conspiracy.

2 And I don't know exactly, like if you talked about
3 Nigel Wood or Colin Bowen, they both testified in their
4 transcripts they didn't even know who Mr. Nagy was. So how
5 could the exception apply there? So we would ask that this
6 broad hearsay exception not be applied in these
7 circumstances.

8 Oh, Your Honor -- and by the way, the comment she
9 made about that confidentiality agreement, he testified over
10 and over about that. He said when he signed it, it meant
11 nothing because Scott Cathcart came on board, and that has
12 been over and over.

13 So I don't know how they can say the signing of the
14 agreement is evidence of he's testified to that fact again.

15 THE COURT: Yes, ma'am?

16 MS. WEIS: Your Honor, first we would say that
17 intent to deceive or harm the IRS or the other party in a
18 case is not a requirement under Rule 801.

19 Second, we say that Mr. Cooper has not cited any
20 cases that would indicate that, to my knowledge. And I just
21 got the brief, so I briefly know what the Court is saying,
22 they do not apply state civil conspiracy law to a Rule 801
23 standard.

24 Third, I would say with the first case that I cited,
25 you, *USF Red Star*, is a civil case. And as the Supreme Court

1 has said in *Abergele* -- I might be butchering that name --
2 but that the, under Rule 801, is the same under civil and
3 criminal cases.

4 So the fact that we've cited criminal cases simply
5 isn't involved here.

6 THE COURT: Okay. Thank you.

7 All right. What's next?

8 MR. CLUKEY: Your Honor, we would like to elaborate
9 a little bit more on our motion -- our request to exclude the
10 McDermott Will & Emery opinion that was discussed on Friday.

11 And Mr. Seador would like to make a few additional
12 comments regarding that.

13 THE COURT: Sure.

14 MR. SEADOR: Good morning, Your Honor.

15 THE COURT: Good morning.

16 MR. SEADOR: We believe that the McDermott Will &
17 Emery memo should not be admitted into evidence for a number
18 of reasons.

19 First of all, let's talk about the facts. The fact
20 of the matter is that this McDermott Emery memo --

21 THE COURT: No. When you start with the facts, does
22 that mean that you concede that the declaration that Mr.
23 Cooper provided to us on Friday is sufficient for Rule 901?

24 MR. SEADOR: No, Your Honor.

25 THE COURT: Okay.

1 MR. SEADOR: The fact of the matter is that on the
2 very first page of this memorandum, in bold type and
3 underlined, it says "This memorandum is not an opinion. It's
4 not an opinion on the 90% transaction and it's not an opinion
5 on any transaction. It's not a tax payment."

6 It says, "This memorandum is not an opinion that any
7 particular stock or tax transaction achieves tax results
8 where that a stock cash transaction, in general to
9 individuals entering into a stock cash transaction, should
10 not rely on this memorandum; they should consult their own
11 tax advisors regarding the applications of the principles set
12 forth in the memorandum."

13 Number two, Mr. Nagy himself admitted that he asked
14 McDermott for a tax opinion on Derivium's 90% Stock Loan, and
15 that McDermott Will & Emery did not give him one.

16 And I have his deposition testimony here where he's
17 asked by Mr. Clukey -- and his deposition was taken just
18 last year -- about whether or not he asked McDermott Will &
19 Emery about his tax opinion.

20 He said under oath, "Evidently Dr. Cathcart asked
21 that I speak to him about a tax opinion" -- him being Jerry
22 Kaplan of McDermott Will & Emery -- "about McDermott
23 providing a tax opinion on the 90% Loan. I assume I did
24 speak to him about that. To my knowledge, nothing ever came
25 of it. I don't recall the substance of the situation,

1 whether it was a situation that Derivium decided it was too
2 expensive or whether McDermott just did not want to do it."

3 If I could have -- if you could pull up Government
4 69 -- and this is an e-mail where we find out, in fact, why
5 McDermott Will & Emery did not provide an opinion, a tax
6 opinion, on the 90% program. And you can pull up the first
7 e-mail in time at the bottom there.

8 And this is from the McDermott Will & Emery. It
9 says: "Upon reflection and consultation with the opinion
10 group partners in our firm, we believe we have a professional
11 responsibility to perform due diligence sufficient to
12 understand Derivium's and the lender's business as it relates
13 to the opinion and to satisfy ourselves that Derivium and the
14 lender would be able to meet their obligations to deliver
15 shares to borrowers willing to repay their loans at the end
16 of the term.

17 "We believe this would include, at a minimum, a
18 review of the lenders, and D.C.'s" -- being Derivium
19 Capital's -- "financial statements."

20 "Although we are willing to consider alternative
21 means of satisfying our due diligence obligation, we would
22 like to know the relationship, affiliation and relationship
23 with the lenders and its principals, Derivium's relationship
24 to the lender."

25 And on the second page: "The lender is subject to

1 insurance or banking regulations and other businesses engaged
2 by the lender."

3 And it says, "We will keep all that information
4 confidential."

5 And if you look at the top -- Sam, if you could zoom
6 into the first page.

7 The second e-mail, we can see what Derivium's
8 reaction to this was: "We can try to be responsive to this
9 short of providing financials, but the part about wanting to
10 know whether or not the lender is subject to insurance or
11 backing regulation and the general "witch hunt" Karch is on
12 over and above what the assignment calls for suggests to me
13 that we will never satisfy them; and even if we could, it
14 would take months to get them to a successful conclusion.

15 "Unfortunately, as much as we like Jerry Kaplan, I
16 think we have to conclude that we are in the wrong pew with
17 McDermott Will & Emery on this and we need to find another
18 firm to work with for tax opinions."

19 And this e-mail is -- this comes one month right
20 after they received the McDermott Will & Emery memo.

21 So now let's talk about the law. And as a matter of
22 law, it is unreasonable for someone to claim a reliance on a
23 tax opinion when that opinion is not -- what's not based on
24 all the relevant facts, or incorrect facts, for that matter.

25 And in the Ninth Circuit under a 2009 case, U.S.

1 versus Kapp, the case cite is 564 F.3d, 1103, that case
2 stands for the unremarkable proposition that a tax return
3 preparer is not considered to have relied in good faith on
4 advice that he received if he knew or should have known that
5 the other party providing advice was not aware of all the
6 relevant facts. It seems like common sense.

7 THE COURT: It seems like you are mixing things up
8 right now. I mean, that might be a nice final charge, but we
9 are talking about evidence now and relevance and
10 admissibility, as opposed to people relying on --

11 MR. SEADOR: That's exactly why we believe it's
12 irrelevant and prejudicial to the jury because he's now
13 saying he relied on a tax opinion.

14 THE COURT: That's what cross-examination is all
15 about, you know. I mean -- you know, I mean, if he wants to
16 take up -- I mean, I can't keep people from taking positions
17 in court. I mean, I can if that's good law. I mean, I'll be
18 glad to charge it to the jury if it's good law. And then you
19 can tell the jury that, you know, that's what the law is, you
20 may say he relied on it, but you just can't do it.

21 Let's talk about the evidence, you get it into
22 evidence, it's a 402 right now, irrelevant. I think that's
23 your objection right now, right?

24 MR. SEADOR: Right. So we have 402 irrelevant, 403
25 prejudicial, because it just doesn't apply to the 90% scheme,

1 and it's not even an opinion on the 90% Stock Loan, and they
2 are saying he received this and relied on it.

3 THE COURT: People can say all kinds of crazy things
4 in court, that's what the jury is for. He can rely that the
5 sun came up in the west. If he wants to say that, that's up
6 to him.

7 MR. SEADOR: We believe under 801 that the document
8 is hearsay and that the declaration submitted doesn't get --
9 doesn't actually authenticate the document.

10 THE COURT: Okay. Now let's go -- you know, now we
11 are back to where I started from, all right?

12 Why does it not authenticate the document?

13 MR. SEADOR: First of all, this document was sent
14 to, apparently Mr. Straus, that we've never spoken about, at
15 the EMC Corporation. There is nobody at McDermott Will &
16 Emery that can authenticate this memo, and there is all sorts
17 of testimony in here that obviously we would want stricken,
18 including his claims that this was some sort of opinion on
19 the 90% Stock Loan Program.

20 THE COURT: You mean testimony in the -- in the
21 declaration?

22 MR. SEADOR: Correct.

23 THE COURT: The declaration is not coming in anyway.

24 MR. SEADOR: That's all I would say, Your Honor.

25 THE COURT: Okay.

1 Yes, sir?

2 MR. COOPER: Starting with 402, 403, whatever this
3 document is, the disclaimers on it, the purpose of it is the
4 structure of the transactions are identical, if not -- and at
5 the very least, similar.

6 Mr. Nagy was able to take two documents and compare
7 his research to understand if his research had a basis. And
8 that's the relevance of it and that's the relevance to the
9 state of mind.

10 That e-mail that he spent a lot of time going over,
11 you are exactly right, they can cross him all they wanted,
12 but I think the thing that jumped out at me is Mr. Nagy is
13 nowhere on that e-mail.

14 And lastly, we believe that not everyone has been
15 satisfied that it's a reliable document and hasn't been
16 altered.

17 THE COURT: All right.

18 What's next?

19 MR. COOPER: I think opening statements.

20 MR. SEADOR: Your Honor, I do have one final
21 housekeeping matter.

22 THE COURT: Okay.

23 MR. SEADOR: When we were going through the exhibits
24 to be admitted into evidence on Friday, there was a series of
25 exhibits that Mr. Nagy had withdrawn objection to, but Mr.

1 Debevc had maintained his objections. And so now, since Mr.
2 Debevc is out of the case, I believe those are to be
3 admitted.

4 If I could read those?

5 THE COURT: Sure. We'll put those in.

6 MR. SEADOR: So Government Exhibits 11, 12, 20, 54,
7 116, 120, 142, 143, and then 38 and 40.

8 THE COURT: Yes, sir?

9 (Thereupon, Exhibit Numbers 11, 12, 20, 38, 40, 54,
10 116, 120, 142 and 143 were received in evidence.)

11 MR. CLUKEY: Your Honor, there were a couple of
12 items from Friday, as well.

13 We brought up this issue about certain facts that we
14 believe to have been established in summary judgment, and we
15 weren't sure if you had a chance to look at what we included
16 in our pretrial brief. We had a statement there and we also
17 had it in the jury instructions.

18 THE COURT: The summary judgment included it's a
19 sale, not a loan, okay? I don't think it's a -- that it has
20 anything to do -- I didn't believe it was material. I guess
21 you've got to prove that.

22 Right?

23 MR. CLUKEY: We would disagree, Your Honor.
24 Materiality and the law does not require reliance by a
25 customer.

1 MR. COOPER: We would totally disagree with that.

2 THE COURT: You win.

3 MR. COOPER: Thank you.

4 THE COURT: You've got to prove materiality.

5 MR. COOPER: And, Your Honor, also just to reraise
6 again -- and I talked to my client now that Mr. Debevc is
7 out -- again, to shorten the trial, we would concede that
8 first part of the Statute that he participated in it, because
9 our reading of the Statute on how broad it is, that if he
10 gave any advice, that would be some sort of participation.

11 I mean, we would like to get the trial down to what
12 this is about, and it's about his tax advice and whether or
13 not he knew there were hedges.

14 So I would just throw it out there one more time, so
15 maybe we could get on the boat this weekend.

16 THE COURT: It takes two to stipulate; we've only
17 got one. So until you start dancing with somebody else -- I
18 mean, we are going to have to stay in the same position.

19 MR. COOPER: I have that problem a lot.

20 MR. CLUKEY: Your Honor, we had also raised with the
21 Court the initial penalty amount. I think we just wanted
22 some clarification on that to make sure we were all on the
23 same page.

24 We thought that you said -- we were wondering
25 whether the ruling is whether the initial penalty amount can

1 be raised, given the fact this is a de novo proceeding and
2 the jury will be deciding how much penalties to impose, if
3 any?

4 THE COURT: Yeah?

5 MR. COOPER: What he's referring to is my
6 Exhibit 68, which is the notice of assessment to Mr. Nagy.

7 That document, regardless of the penalty amount, is
8 critical for us to prove evidence that the IRS didn't assess
9 that penalty until four and a half years after the close of
10 the audit, and that is a critical piece of evidence in our
11 case.

12 And we also do think it is relevant, the amount,
13 because that's the amount that still sits on Mr. Nagy's tax
14 lien down at the Charleston Courthouse.

15 MR. CLUKEY: Your Honor, the fact of the
16 investigation certainly occurred during the scheme, and so
17 the IRS told Mr. Nagy that he was under investigation under
18 6700 in 2004. The penalties weren't assessed until the
19 scheme was basically over, Derivium was defunct.

20 And so there are no penalties that are pending from
21 the time that the assessment actually came out, I believe it
22 was in 2007, so it can have no bearing on his scienter,
23 because those years aren't at issue. The penalties go up
24 through 2005 when they stopped. That's the only issue before
25 the jury. So that fact would have no bearing on the

1 scienter.

2 In addition, there is also -- in addition to that,
3 there is also our concession, the Government conceded the
4 penalties for 1997 and the Government recalculated the proper
5 amount of the penalties for this last portion of 2004 and
6 2005 because the Statute changed, and the IRS did a different
7 calculation. And so we've recalculated and now are
8 requesting the jury to impose what we believe to be the
9 proper amount of the penalty.

10 And given the fact that this is a de novo review and
11 that has been litigated in this case on multiple occasions,
12 and the Government has prevailed on that issue more than
13 once, we believe that that -- that this -- these subsequent
14 events should not have any relevance. The concession memo is
15 Exhibit 91 and I think he referenced 61.

16 THE COURT: 68, I think you said.

17 MR. COOPER: Yes, Your Honor.

18 Let me point out one thing in your motion in
19 limine -- and this is why that kind of argument of him saying
20 that Mr. Nagy knew he was under investigation in '04 --
21 Exhibit 65, the 6700 letter to Mr. Nagy when the -- when it
22 was begun, it didn't start until March of '06, he just said
23 '04. And this is the problem we are going to have with the
24 trial with all this information being kept out.

25 And in addition to the damages penalty, he's

1 indicating that I have to prove the amount of damages, or
2 it's my burden.

3 Now, if the Government, after doing this from '06 to
4 '08, can't get the penalty amount right, I think that's
5 something I get to cross people on and bring in and show the
6 jury that this is complicated, and it's not clear, because
7 that's critical.

8 They -- they did a calculation after two years of
9 work and it was completely wrong. And I should be able to
10 bring that in and argue it.

11 MR. CLUKEY: Your Honor, Mr. Nagy admitted during
12 his deposition that he knew about the IRS's investigation in
13 2004. He admitted that fact.

14 The penalty amount is statutory. It's two separate
15 issues. It's the issue of whether he engaged in the conduct.
16 And if he did, he can be enjoined and the fact Mr. Nagy has
17 been enjoined from further promoting this scheme. So that's
18 one aspect of the Statute. Separate from that, penalties can
19 be imposed if you've engaged in that conduct.

20 So it's predicate to the penalties being imposed.
21 The Government does obviously have the burden of proof of
22 showing that Mr. Nagy engaged in the conduct, and then
23 pursuant to the cases we cited and we argued on Friday, Mr.
24 Nagy then -- the burden of proof then shifts to Mr. Nagy to
25 prove the amount of the penalties.

1 And part of the penalties, the later years, those
2 penalties are based on the amount of money that he earned
3 from the scheme.

4 Mr. Nagy didn't even produce his billing records to
5 the Government until late in -- late in 2009. We asked for
6 those informally from Mr. Cooper in early 2009.

7 I asked Mr. Nagy about this during his deposition.
8 I said, What took you so long to give us these records? And,
9 you know, he just said it just took him a while.

10 So we finally got those records just prior to his
11 deposition.

12 THE COURT: Okay. And what kind of penalties did
13 you assess Mr. Nagy on that last issue prior to receiving his
14 billing records?

15 MR. CLUKEY: The IRS had taken -- it's basically
16 what they do in a whipsaw position.

17 THE COURT: What's a whipsaw position?

18 MR. CLUKEY: Let me explain that.

19 They took the -- when the Statute changed in
20 October, 2004, the way you calculate the penalties is you
21 take all the income that has been earned by the scheme that
22 someone has earned, or could have earned, you can use billing
23 records if there is no receipts. So the IRS in -- all this
24 which was done in 2006, by the way, Your Honor.

25 So the IRS took all the income that was earned by

1 the scheme because they didn't know who earned the income,
2 they just knew how much income had been earned by the scheme.
3 They assessed Charles Cathcart, Yuri Debevc, Scott Cathcart,
4 and then Mr. Nagy, and waiting to find out how much income
5 each person earned.

6 So we, of course after this case came out, we asked
7 for the billing records so we could find out how much he
8 really earned. Once we figured it out, we dropped the amount
9 of the assessment -- the assessment is significant, it was
10 about \$5 million -- and when we figured out what we thought
11 the penalty should be, how much he really earned, took it at
12 face value to the billing records he provided to us, I think
13 the last part of 2004 is approximately 20,000, and it's about
14 57,000 for 2005.

15 THE COURT: You said 5 million and dropped it
16 significantly?

17 MR. CLUKEY: Correct.

18 MR. COOPER: Your Honor, first of all, in the --
19 after March of '06 -- and they had an investigation on Mr.
20 Nagy -- the IRS never asked for a single document from Mr.
21 Nagy. So of course they didn't know what his billing records
22 were.

23 Secondly, the way they assessed the penalty, the
24 penalty is 50 percent of the income that you derived or
25 expect to derive from the plan or arrangement.

1 What they did is they took all of Derivium's income,
2 all of it, 100 percent, 10 percent of the collateral value,
3 right? That is what they said the profit of Derivium was,
4 that remaining ten percent, and they allocated 100 percent of
5 that to Mr. Nagy, and then they chopped it in half. They
6 knew from the audit, and they've always known from Derivium's
7 corporate papers, that Mr. Nagy didn't own a single percent
8 interest in Derivium.

9 So how he could earn 100 percent of Derivium's
10 money -- and this is one of those issues we want to talk
11 about -- here is the assessment, it's difficult, and I need
12 to be able to argue to the jury that these calculations are
13 not easy.

14 MR. CLUKEY: Your Honor, one last thing.

15 The amount of the assessment has no bearing on
16 whether he engaged in this conduct years earlier; it's just
17 not relevant to his conduct.

18 Mr. --

19 THE COURT: It's relevant to the case.

20 MR. CLUKEY: It is.

21 THE COURT: It may not be relevant to the conduct;
22 it's relevant to the case because the burden shifts to him to
23 say what the penalties should be.

24 MR. CLUKEY: Well, if it's a de novo proceeding,
25 Your Honor, we are not entirely clear what the IRS thought

1 the penalty was years earlier, how that can have any bearing
2 on what the jury is going to be asked to decide, what the
3 Government has now conceded that the penalty amount was too
4 large.

5 In addition, Your Honor, if -- if Your Honor
6 concludes that it is relevant, we would ask -- we think this
7 could be bifurcated very easily. The jury could decide
8 whether he was liable, and then we have a single -- a single
9 witness that we are calling on the amount of penalties. He's
10 just a summary witness. He will testify about what we
11 believe the penalty should be. We think it's like an hour's
12 worth of testimony. It would be a very easy matter to
13 bifurcate, if you thought what the IRS was doing somehow
14 played into the proper calculation of the penalty. But to
15 introduce it during the case in chief, we believe would be
16 unfairly prejudicial, Your Honor. Because as I keep saying,
17 this is a de novo proceeding.

18 Thank you.

19 MR. COOPER: Your Honor, we would just rather not
20 bifurcate it and do it all at once, but I think I've argued
21 everything else.

22 THE COURT: What he wants to do is do it all at once
23 and have the jury finding whether what liability, for lack of
24 a better term, and then if, in fact, the jury finds that he
25 is quote/unquote liable, then the Court will have a damages

1 hearing, which is one witness. That's my understanding.

2 Is that right?

3 MR. CLUKEY: That's correct, Your Honor.

4 THE COURT: Okay. Anything else?

5 MR. COOPER: Not from me, Your Honor.

6 THE COURT: Okay.

7 MR. CLUKEY: No, Your Honor.

8 THE COURT: Who is going to open for the Government?

9 MR. CLUKEY: I am, Your Honor.

10 THE COURT: All right. And I don't, like I said, I
11 don't keep time. How long do you think you are going to be?

12 MR. CLUKEY: About 40 minutes.

13 THE COURT: Okay. How about you?

14 MR. COOPER: Cut that in half.

15 THE COURT: I won't hold you to it, all right?

16 MR. COOPER: Thank you, Your Honor.

17 THE COURT: All right.

18 MR. COOPER: And although he's going to present his
19 case first, since I'm the plaintiff, do I get to open first?

20 THE COURT: No. He gets to go first. Take it up to
21 the Fourth Circuit. I decided that last week.

22 MR. COOPER: Yes, Your Honor.

23 THE COURT: All right.

24 As far as bifurcation, I think it's a good idea to
25 bifurcate the matter of the penalties for the reason that you

1 just brought up, all right? Under penalties, you have the
2 burden of proof, so you get to go first, and then you get to
3 go last. And the first part of the case he gets to go first
4 and he gets to go last. So that gives you the two arguments
5 on the amount of the penalties.

6 MR. COOPER: Well, let me ask you this -- and I'm
7 sorry I'm -- if -- for Exhibit 68, which is the assessment, I
8 can still bring that in to show when the assessment was made?

9 THE COURT: You mean the date of the assessment? I
10 mean, I don't know if that has bearing on something else.

11 MR. COOPER: Yes. I mean, it's my theory of the
12 case, when the audit happened, when the assessment happened.

13 MR. CLUKEY: Your Honor, we'll concede the date of
14 the assessment.

15 MR. COOPER: So I can show the document?

16 MR. CLUKEY: We object to the document. We would
17 stipulate to the date of the assessment.

18 MR. COOPER: Well, I mean, the document is very
19 powerful. May I redact out -- I mean, I don't want to redact
20 out the numbers, but I would still like to be able to show
21 them the document because it's an IRS document.

22 THE COURT: If you want to -- if you wanted to
23 redact it, that's fine. Perhaps it will get in in the
24 bifurcated hearing. I mean, I might let it in, but we will
25 have to wait for the bifurcation, okay?

1 Because, I mean, if -- I don't want -- Mr. Nagy, you
2 need -- Mr. Nagy, you need to pay attention to what I'm
3 saying rather than whisper to your lawyer, because he needs
4 to pay attention to what I'm saying. You will have plenty of
5 time to talk to him.

6 MR. NAGY: Yes, Your Honor.

7 THE COURT: The reason for that is that that date
8 may be important in your theory of your defense case, and it
9 may have another reason for your plaintiff's case, which is
10 the second part of that.

11 If, in fact, the first part of the case -- you win
12 the first part of the case, then we don't even go to the
13 second part of the case, we really don't need the document at
14 all except for the date, okay?

15 MR. COOPER: Okay. I mean, I would just, for the
16 jury -- I mean, to put -- I mean, it's all about context,
17 Your Honor, and there is millions of dollars at issue.

18 THE COURT: I understand.

19 MR. COOPER: And I think the jury has got to
20 understand that. I mean, this is a significant. It's not
21 like they are going to slap him on the wrist. I mean, it's
22 millions of dollars my client is facing. And if the IRS
23 sends that document, doesn't it do so at its own peril and
24 can't I show the jury that to show what they did at that
25 point in time? I don't understand why I can't bring that

1 number in.

2 THE COURT: Because I said so.

3 MR. COOPER: Yes, Your Honor. Okay. You are right.
4 Yes, Your Honor.

5 THE COURT: All right? For lack of a better reason.

6 All right, and as far as the coconspirator
7 exception, I'm going to overrule your objection to that. You
8 are talking about state court; we are talking about
9 coconspirator and an evidentiary matter, as long as they
10 establish the conspiracy to begin with. And the
11 coconspirator exception would apply -- no-change letter can
12 still come in with regard to Mr. Nagy's state of mind. It's
13 a scienter case. I think it's very important.

14 As far as the McDermott Will & Emery report, I'll
15 overrule your objection to that. It can come in as to his
16 state of mind, and then you can cross-examine him on it, and
17 he acted really stupid for relying on it, and the jury can
18 take that just because the no-change letters come in, this is
19 fraught -- if you start coming out there and telling the jury
20 that this no-change letter means everything, it was A-1
21 proved by the Federal Government, I'm going to define it at
22 the end that it's not going to say that.

23 The Ninth Circuit case that they cited last week of
24 the definition of a no-change letter is what the jury is
25 going to be told, which essentially says it really doesn't

1 mean anything. You can argue anything you want, but the jury
2 is going to be told that as a matter of law.

3 So Mr. Altemose is not going to come in here and say
4 it's the gold standard. You can argue anything you want as
5 far as what you think it is. I'll tell the jury today that
6 what the lawyers say is not evidence, it's just argument and
7 it's not the law; it's just argument. So you can say
8 anything you want, you've got a First Amendment right, but
9 I'm just telling you you ought to be careful, okay?

10 I understand you don't like it.

11 MR. COOPER: Yeah, but Your Honor, the Ninth Circuit
12 case -- again -- and the confusion is there is a difference
13 between tax and penalty. We cited you a plethora of -- not a
14 plethora, we cited you cases that say that when a no-change
15 letter is issued, it can be used as a defense to penalties
16 under the reasonable cause basis, so we would agree that for
17 tax purposes, yes, but for penalty purposes -- I mean,
18 that's -- I think that's the distinction that's being lost
19 here. This is a penalty case.

20 THE COURT: Okay. Well, maybe we'll have one
21 standard of in the quote/unquote liability case, and that
22 shows the wisdom of bifurcating the case because you may have
23 another standard in the penalty phase.

24 How about that?

25 MR. COOPER: Well, I mean, but the penalty is going

1 to apply if they find a violation of 6700. So then it's my
2 job to chop it down, right?

3 But his state of mind -- because those cases say
4 it's a defense to penalties -- I mean, that's what those
5 cases say. So if that's the law -- and there is not a lot of
6 6700 cases out there, Your Honor. This is not an everyday
7 case. If the law is in aspects of the Internal Revenue Code
8 that a no-change letter is a defense to the assessment of
9 penalty, and this is a penalty case --

10 THE COURT: Not until the second half of it.

11 MR. COOPER: But that -- that's what I don't
12 understand. If they show he violated 6700, the penalty
13 applies.

14 THE COURT: Then you get to litigate the penalty in
15 the second half of the case.

16 MR. COOPER: So you are saying that if I can take
17 that no-change letter and demonstrate, Mr. Altemose could
18 then come in and say this is the gold standard?

19 THE COURT: Maybe in the second half of the case,
20 but not in the violations state of the case.

21 MR. COOPER: Okay.

22 THE COURT: I mean, it's relevant to his --

23 MR. COOPER: State of mind.

24 THE COURT: -- scienter, state of mind.

25 He can say everything he wants as to what the

1 memorandum that was in their files in 2001 of state of mind,
2 okay?

3 All right. So I'm not telling you you can't say
4 anything you want to say, and he can't say anything he wants
5 to say; I'm telling you that you better watch out.

6 MR. COOPER: Thank you.

7 THE COURT: Okay.

8 All right. Is there anything else y'all talked to
9 me about that I haven't decided?

10 MR. COOPER: Not that I'm aware of, Your Honor.

11 THE COURT: So we'll be at ease, and you can
12 arrange, and the jury is going to have pens and pencils and
13 all that to take notes, and you can argue from anywhere you
14 want. You can question from anywhere you want. You can
15 approach any witness you want to. If you've got one that is
16 hostile, if he hits you, that's not problem, but you can do
17 that. You can give the witness whatever you want. You can
18 give the exhibits to the jury if you think you need to do
19 that. And I don't have any problem with that whatsoever, all
20 right? So --

21 MR. SEADOR: Your Honor, we have two boxes of our
22 binders of exhibits for the Court. If you would prefer to
23 look at those rather than hard copies?

24 THE COURT: Um, we'll just bring them up here. And
25 if we need them, we'll do that.

1 And you've still got yours?

2 MR. COOPER: They are right down there. I would
3 just ask if they are going to show them, if I could look at
4 them.

5 THE COURT: Oh, sure. You mean for in opening?

6 MR. COOPER: Yes, Your Honor.

7 THE COURT: Yeah. As long as it's in evidence or
8 demonstrative, you probably already talked about it.

9 We'll wait until all the jurors get here and start,
10 okay? Thanks.

11 (Thereupon, there was a recess.)

12 THE COURT: Okay. Anything else before we bring the
13 jury in?

14 All right. We are down to nine because this case is
15 causing people to be sick. Another one was at the VA
16 Hospital, and he's got about 18 medications and high blood
17 pressure and yada, yada, yada, but he's better off than the
18 guy that fell and is in a coma for a couple of days and the
19 woman who has shingles. They had other things to concentrate
20 on.

21 I'm going to give them a short opening charge, very
22 generic, burden of proof and all that kind of stuff, and then
23 go to Mr. Clukey, okay?

24 (Thereupon, the jury entered to the courtroom.)

25 THE COURT: Okay. Why don't y'all everybody shift

1 this way, if you want to go to the back row, because this is
2 where the action is right here. That's the witness stand.
3 So the closer you can get there, the better you'll be. And
4 you can pass out those pens and pencils. And if you want to
5 take notes, you are welcome to do so.

6 If y'all decide to take notes, you can either take
7 them back to your jury room or turn them upsidedown in the
8 chair; nobody will bother them, okay?

9 And I'm David Norton, I'm the trial judge. You've
10 never seen me before. I think I was out of town when y'all
11 were selected. So I'll be trying this case with y'all.

12 So since you've already been sworn as the jury to
13 try this case, I'm going to give you some preliminary
14 instructions at this time.

15 At this trial, you will decide the disputed issues
16 of fact in this case and I'll decide all questions of law
17 that arise during the trial. And before you retire to
18 deliberate together and decide the case at the end of the
19 trial, I'm going to instruct you again on the rules of law
20 that you must follow and apply in reaching your decision.
21 And you will have a copy of that charge, so you can go over
22 it.

23 Now, because you will be called upon to decide the
24 facts in this case, you should give careful attention to the
25 testimony and the evidence presented for your consideration

1 during this trial, but you should keep an open mind and
2 should not form or state any opinion about the case one way
3 or the other until you've heard all the evidence and have had
4 the benefit of the closing arguments of the lawyers, as well
5 as my final instructions to you on the applicable law.

6 Now, during the trial, you must not discuss the case
7 in any manner among yourselves or with anyone else. And you
8 must not permit anyone else to attempt to discuss it with you
9 in your presence. The reason for these cautions will be it
10 will be your duty to decide this case only on the basis of
11 the testimony and evidence that is presented during this
12 trial without consideration of any other matters whatsoever.

13 Now, from time to time during the trial, I may be
14 called upon to make rulings on law or motions or objections
15 made by the lawyers. You should not infer or conclude from
16 my ruling that I might make that I have any opinions on the
17 merits of the case favoring one side or the other.

18 If I sustain an objection to a question that goes
19 unanswered by a witness, you should not speculate on what
20 answer might have been given; nor should you draw an
21 inference or conclude from the question itself.

22 During the trial, it may be necessary to confer with
23 the lawyers from time to time out of your hearing concerning
24 questions of law or procedure or evidence that should be
25 considered by the Court alone.

1 On some occasions, you may be excused from the
2 courtroom as a convenience to you and to discuss the matters
3 with the lawyers, but everyone is going to try to avoid such
4 interruptions as much as possible. You should remember at
5 all times that you should be patient, even though the case
6 may seem to be going slowly.

7 In that regard, the case is going to last probably
8 into sometime next week, okay? It will last this entire
9 week. There will be no court on Monday, okay? But then it
10 will start again on Tuesday next week.

11 Now that in order that you might better understand
12 the beginning of the case and the nature of the decisions you
13 will be asked to make and how you should go about making
14 them, I'm going to give you some preliminary instructions at
15 this time concerning some of the rules of law that may apply.
16 Of course, these preliminary instructions that I give you now
17 will not cover all the rules of law applicable to this case.

18 As I said before, I'll instruct you fully at the end
19 of the trial just before you retire to deliberate on your
20 decision, and will probably restate at that time some of the
21 rules of law I want to tell you about now.

22 In any event, you should not single out any one
23 instruction alone in stating the law, but you should consider
24 all my instructions as a whole. This case involves a
25 transaction known as the 90% Stock Loan Program a man by the

1 name of Charles Cathcart developed and a man by the name of
2 Yuri Debevc, through Derivium Capital LLC, also known as
3 Derivium, which they owned and controlled.

4 Mr. Nagy is a certified public accountant and he
5 provided tax memoranda and other accounting services to
6 Derivium concerning the program.

7 The United States claims Mr. Nagy is subject to
8 civil penalties under Internal Revenue Code 6700. Because of
9 his participation in the organization of the sale of the 90%
10 Loan Program, the United States alleges that Mr. Nagy,
11 through his involvement in the organization and/or sale of
12 the 90% Loan Program, may, or caused to be made, false
13 statements with regard to certain aspects of the 90% Loan
14 Program.

15 The United States alleges that these statements were
16 material; that these statements were false or fraudulent, and
17 that Mr. Nagy knew or had reason to know that the statements
18 were false or fraudulent. At the close of the evidence, I'll
19 explain the legal standards for evaluating each of these
20 elements.

21 Now, Mr. Nagy denies that he's liable for penalties
22 under Section 6700 and challenges the amount of penalties
23 assessed against him. Although the Government has assessed
24 penalties against Mr. Nagy, you will hear referred to Mr.
25 Nagy as the plaintiff and the Government as the defendant.

1 Your job in this case is to decide whether Mr. Nagy
2 is liable for the penalties assessed against him under
3 Internal Revenue Code 6700. And if you decide that the
4 plaintiff is liable, you will then have to decide the proper
5 amount of penalty that the plaintiff should pay after you
6 decide whether he's liable or not.

7 This is a civil case. The United States has the
8 burden of proving a violation of the Internal Revenue Code
9 6700 by a preponderance of the evidence.

10 When a person has the burden of proof on any claim
11 by the preponderance of the evidence, it means that you must
12 be persuaded that the claim is more likely true than not
13 true.

14 To put it differently, if you were to put the United
15 States and Mr. Nagy's evidence on opposite sides of some
16 scales, the Government wins if the scales tips slightly in
17 its favor. Some of you will know that in criminal cases the
18 burden of proof is beyond a reasonable doubt. That is a much
19 stricter standard. It requires a lot more proof than a
20 preponderance of the evidence, and the reasonable doubt
21 standard does not apply in this case and you should therefore
22 put it out of your mind.

23 Now, because the United States has the burden to
24 prove its case by the preponderance of the evidence, it must
25 prove that it is more likely or not that Mr. Nagy engaged in

1 conduct subject to Penalty Code 6700.

2 Accordingly, if the United States proves by the
3 greater weight of the evidence that Mr. Nagy engaged in
4 penalty conduct, you must vote in favor of the Government on
5 that issue. Of course, if the Government fails to meet this
6 burden, your verdict then must be for Mr. Nagy.

7 If the United States proves that Mr. Nagy violated
8 the Internal Revenue Code 6700, then the burden will shift to
9 him, to Mr. Nagy, to prove by a preponderance of the
10 evidence, number one, that the amount of the penalties
11 assessed against him should be less; and two, the proper
12 amount of penalties that should be applied to him. We will
13 not go into that until y'all decide the burden on issue one.

14 Now, in determining the facts of this case, you
15 should consider the following evidence: The sworn testimony
16 of evidence, both on direct and cross-examination regardless
17 of who called the witness. Any exhibits that are received
18 into evidence and any facts the lawyers have stipulated to.

19 Certain things are not evidence, and you may not
20 consider them in determining what the facts are: The
21 arguments and the statements by lawyers are not evidence.
22 The lawyers are not witnesses. What they say in their
23 opening statements, closing arguments and at other times is
24 intended to help you interpret the evidence, but it is not
25 evidence.

1 If the facts as y'all remember them differ from the
2 way the lawyers have stated them, your memory then controls.

3 Questions and objections by the lawyers are not
4 evidence. Attorneys have a duty to their clients, and to the
5 Court, to object when they believe a question is improper
6 under our Rules of Evidence. You should not be influenced by
7 the objection or by my ruling on it. If the objection is
8 sustained, you should disregard the question. If it is
9 overruled, treat the answer just as any other answer.

10 Testimony that has been excluded or stricken, or
11 that you have been instructed to disregard, is not evidence
12 and must not be considered.

13 In addition, if testimony or exhibits are received
14 only for limited purposes, you must follow the limiting
15 instructions that I will have given you. And of course,
16 anything that y'all have seen or heard outside the Court is
17 not evidence. You are to decide this case solely on the
18 evidence at this trial.

19 Now, as you listen to the testimony, you should
20 remember that you all are the sole judges of the credibility
21 or the believability of the witnesses and the weight to be
22 given to any witness's testimony.

23 In deciding whether to believe or disbelieve any
24 witness, you should consider his or her relationship to the
25 Government or Mr. Nagy. His or her interest, if any, in the

1 outcome of this case. His or her manner of testifying. His
2 or her opportunity to observe or acquire knowledge concerning
3 the facts about which the witness testifies. His or her
4 candor, fairness and intelligence. The extent to which the
5 witness has been supported or contradicted by other credible
6 evidence. You may, in short, accept or reject the testimony
7 of any witness in whole or in part.

8 Now, during the trial, you will hear and receive all
9 the evidence which may be properly considered in reaching
10 your verdict. You are not permitted to gather information,
11 investigate, or do anything else to learn about this case,
12 including researching facts or terms you may hear during the
13 trial.

14 Specifically, you may not, under any circumstances,
15 form any research regarding any issue related to the case on
16 the Internet. This includes searches on Google, Wikipedia,
17 Yahoo or any other Internet search engine. You should not
18 send or receive any witness by e-mail, text mail or any other
19 electronic media. Moreover, you may not communicate with any
20 juror or anyone associated with the case if you have any
21 social media. This includes, or is not limited to, Twitter,
22 adding such person as a friend, contact, on Facebook, My
23 Space, or any social networking site. And you must avoid
24 exposure to any media coverage of this case on television, on
25 the radio, in the newspapers, on the Internet or otherwise

1 until after your verdict has been rendered.

2 Now, the question sometimes arises as to whether
3 jurors can take notes. Obviously, you can take notes,
4 because I wouldn't have given you pencils and pads.

5 On the other hand, you don't have to take notes if
6 you don't want to. That will be left to each one of you
7 individually.

8 If y'all decide to take notes, be careful not to get
9 so involved with note taking that you become distracted from
10 the ongoing proceedings. Also, your notes should be used
11 only as aids to your memory, and if your memory should later
12 differ from your notes, you should rely on your memory. If
13 you don't take notes, you should rely on what your own
14 independent recollection of what the testimony was. You
15 should not be unduly influenced by the notes of the other
16 jurors. Notes are not entitled to any greater weight than
17 the recollection or impression of each juror as to what the
18 testimony is.

19 Now, you will notice that a complete record of the
20 trial and all the testimony is being recorded and transcribed
21 by the court reporter; however, you should not expect to have
22 typewritten transcripts available in your jury room.
23 Preparation of a transcript is a time-consuming job. It is
24 not completed until long after the trial itself. You will be
25 required to rely your own individual collective memories

1 during your deliberations.

2 On the other hand, any papers or other tangible
3 exhibits that are received into evidence will be available to
4 you for your study in your jury room during your
5 deliberations.

6 On some occasions during the trial, exhibits may be
7 handed to you for brief inspection to you in the jury box.
8 You will get to see and inspect at the end of the trial all
9 the exhibits that you have received into evidence.

10 Now we are going to begin the trial by affording the
11 lawyers an opportunity to make opening statements to you in
12 which they may explain issues in the case and summarize the
13 facts as they expect the evidence will show.

14 After all the testimony and evidence has been
15 presented, the lawyers will then get another opportunity to
16 address you at the end of the trial and make their final
17 arguments of the case. The statements that the lawyers are
18 making now, as well as the arguments that they present at the
19 end of the trial, are not to be considered by you as evidence
20 in the case, which comes from the witness stand and exhibits,
21 or your instructions on the law, which comes from me.

22 Nevertheless, these statements or arguments are
23 intended to help you understand the evidence as it may come
24 in, the issues or disputes you will be called upon to decide,
25 as well as the position taken by each side.

1 So I'm going to ask you that you now give the
2 lawyers your close attention as I recognize them in turn for
3 the purpose of openings.

4 Mr. Clukey and Mr. Cooper? Come over here for a
5 second.

6 (Thereupon, there was a brief off-the-record
7 discussion.)

8 THE COURT: Okay. Mr. Clukey, I'll be glad to hear
9 from you, sir.

10 MR. CLUKEY: Thank you.

11 Ladies and gentlemen, the case that you are here is
12 about deception. It's about deception and false statements
13 regarding the billion dollar tax scheme.

14 The deception starts with the name of the scheme
15 itself. It was called the 90% Loan Program. But the truth
16 is, there was no loan.

17 In fact, this very court has already ruled there was
18 no loan, and this court has ruled that statements claiming
19 there was a real loan, those were false statements.

20 Ladies and gentlemen, the evidence will show that
21 the 90% loan scheme was perpetrated by this man here, Robert
22 Nagy. Perpetrated by Mr. Nagy and by others, including
23 Charles Cathcart, Yuri Debevc, Charles Cathcart's son, Scott,
24 and by a company called Derivium, that you just heard about,
25 Derivium Capital.

1 Derivium Capital is at the heart of the scheme.
2 Derivium was owned by those gentlemen there, Cathcart and Mr.
3 Debevc, it was not owned by Mr. Nagy.

4 But the evidence will show that Mr. Nagy told
5 Derivium Capital this program was a real loan under the tax
6 laws.

7 As you just heard me say, those are false
8 statements. Mr. Nagy provided those false statements to
9 Derivium Capital, provided them to its owners, and Derivium
10 Capital shared those false statements with its marketing
11 people. And its marketing people, in turn, shared those with
12 customers.

13 Mr. Nagy provided those false statements in tax
14 memos, and those tax memos were also given to customers, and
15 Mr. Nagy communicated those to customers. He talked directly
16 to customers, too.

17 The evidence will show the 90% loan scheme roots
18 here in Charleston South Carolina, but from here, it spread
19 across the United States and beyond the far reaches of the
20 globe, distant shores such as the Isle of Man, Ireland, Hong
21 Kong, St. Vincent and the Grenadines.

22 The 90% loan scheme really started in 1997 and it
23 was wildly successful. It continued on until 2005 and
24 eventually collapsed. Mr. Nagy was involved almost from the
25 beginning, 1997, until its end.

1 The evidence will show the 90% loan scheme targeted
2 customers who were well-to-do. You had to have at least
3 \$100,000 in stock to be able to participate in this scheme.
4 If you did, you are lucky enough to have \$100,000 stock.
5 Derivium Capital told you that this was a real loan.

6 Now, the amount of the loan you were told you would
7 get was 90 percent of the face value of the stock. That's
8 why they called it the 90% Loan Program.

9 So for example, you had \$100,000 worth of stock, you
10 went to Derivium, you gave that stock to Derivium Capital.
11 Derivium, in turn, would give you back \$90,000, 90 percent of
12 \$100,000, and they told you when they did that, that it was a
13 real loan. They also told you that your stock was going to
14 be collateral; told you it would be collateral.

15 The truth is, ladies and gentlemen, as soon as
16 Derivium Capital got a customer's stock, they sold it. They
17 sold the stock before the transaction was even finalized.
18 They sold the stock before the customer ever got a penny.

19 The truth is, there was no loan, it was just a sale
20 of stock. And you already heard me tell you this Court has
21 already ruled there was no loan.

22 Ladies and gentlemen, the truth is there was no
23 collateral. What's collateral? You know what collateral is?
24 Collateral is something valuable to ensure repayment, like a
25 house. You go buy a house, you put down some money, you also

1 get a loan from the bank, and the bank gives you money. If
2 you don't repay that loan, the bank can take that house. The
3 house is collateral.

4 Well, customer stocks weren't collateral because
5 they sold them, sold it on the open market, and the stock was
6 gone. They sold it before the transaction started.

7 Ladies and gentlemen, the evidence will show that
8 customers were told this transaction was tax free.

9 Now, what kind of tax are we talking about? Stock.
10 Taxes on stock. Everybody knows that when you buy stock, you
11 want to buy low. You want to buy low; you want to sell high.

12 If you can do that, buy low, sell high, the
13 difference there is your profit. And with the good comes the
14 bad. You got that profit, you have to pay taxes on that
15 money. Those taxes are called capital gains taxes.

16 What Derivium -- what Mr. Nagy told customers is
17 that you don't have to pay capital gains taxes on this
18 transaction, on this particular transaction. You don't have
19 to because it's a loan; it's not a sale.

20 The truth is, it was a sale and you do have to pay
21 capital gains taxes on those profits. Ladies and gentlemen,
22 customers were told that there was a real lender involved in
23 this scheme. There was no lender. There were paper
24 companies, shell companies that didn't do anything.
25 Everything happened at Derivium. Derivium controlled all the

1 stock. They controlled the entire transaction. There were
2 no lenders involved. And you didn't need a lender because
3 all you did was you took commerce stock, you sold it, and you
4 gave them back 90 percent of their own stock and you kept ten
5 percent.

6 Now, ladies and gentlemen, in addition to the tax
7 benefits customers were bringing in, they were given a no
8 lose proposition. They were told, give us your stock, we'll
9 give you this loan. And if your stock goes down in value and
10 you can't repay the loan, don't worry about it. Keep all the
11 money that we've given you. Keep all the money. Don't pay
12 it back. Don't pay it back.

13 In addition, although we are charging you interest,
14 supposedly under this loan, don't pay any interest. Keep
15 everything.

16 On the other hand, if your stock goes up, if your
17 stock goes up, you can get it back. If your stock goes up,
18 doubles, triples, goes up ten times in value, you can get the
19 stock back, just repay the amount we gave you, the interest,
20 and you get the stock back no matter how much it goes up.
21 Unlimited upside, they would call it. As part of that,
22 customers were told that Derivium Capital would hedge the
23 transactions.

24 Now, what's a hedge? You are going to hear
25 testimony throughout this trial about what a hedge is. For

1 example, you are going to hear testimony from a professor
2 from Stanford University, Paul Pfeiffer. And Professor
3 Pfeiffer is a professor in economics and finance. And he's
4 going to explain what a hedge is.

5 Basically, it's a protection against risk. In this
6 case, it was a protection that customers would be able to get
7 their stock back and be able to get their stock back if it
8 went up dramatically in price.

9 The truth is, ladies and gentlemen, there was no
10 hedge. There was no hedge. Derivium, because they sold the
11 stock, they didn't have it, they couldn't give it back if the
12 customer wanted it back. They didn't do any financial
13 transaction. They didn't engage anything to ensure that the
14 customers could get their stock back.

15 Now, ladies and gentlemen, on its surface, this
16 scheme is complex, but over the coming days, you are going to
17 see in the end the deception is really pretty simple. And
18 you are going to see that the scheme itself isn't really that
19 complicated; it's pretty straightforward.

20 I'm going to ask you to be detectives in this case
21 and I'm going to ask you to follow the evidence. And there
22 is going to be a lot of it, lot of documents, different
23 witnesses. I'll ask you to follow the evidence from here in
24 Charleston to California to some of those countries I just
25 mentioned, like the Isle of Man, Hong Kong.

1 So who is Robert Nagy? Robert Nagy is an
2 accountant. He's not just an accountant, he's the only
3 accountant, the only person who would tell Derivium Capital
4 in writing, is that Derivium Capital could use those memos to
5 customers who could rely on that advice. He was the only
6 person to tell Derivium that this was real, it was a real
7 loan under the tax loans. Nobody else would do that. This
8 was a billion dollar scheme, and no other accountant, no
9 other lawyer, no other law firm, nobody would tell Derivium
10 that this was a real program, this was a real loan.

11 And you might hear testimony in claims that Mr. Nagy
12 was independent, he was a third party outside advisor, he
13 didn't own Derivium, that's true; but you are also going to
14 see evidence that Mr. Nagy considered Derivium as a number
15 one priority client.

16 And Mr. Nagy profited from Derivium not just for
17 providing tax advice, Mr. Nagy profited from doing things
18 like editing marketing materials. He will admit that. He
19 profited from loan documents, the contractual documents that
20 are actually used with customers. Mr. Nagy profited from
21 talking directly with customers. Mr. Nagy profited from
22 doing other things for Derivium, providing other tax
23 services, accounting services, preparing tax returns. He
24 prepared the tax returns for Charles Cathcart, Charles's son,
25 Yuri Debevc. He prepared the tax returns for other

1 companies, too.

2 And Robert Nagy didn't just profit from the work he
3 was doing for Derivium Capital, he was profiting from a whole
4 host of companies that were interrelated to this scheme.
5 Actually, I want to talk about a couple of those real
6 quickly.

7 Now, to help you understand some of the companies in
8 this case, because the promoters of the scheme created a
9 whole bunch of different entities, I prepared a little chart
10 here -- well, a big chart.

11 And so we have been talking about this company here,
12 Derivium Capital. It's had some history over the years. We
13 are going to get into this over the course of the trial, I'm
14 not going to talk about all that now, it's called First
15 Security Capital, and some other things happened throughout
16 the years and it split off. It was sued; decided to create
17 new companies. Well, Mr. Nagy profited from these companies
18 here.

19 And we see right here, something called startup
20 companies. Those startup companies were owned by the owners
21 of Derivium Capital. They are owned by Charles Cathcart, his
22 son Scott, and Yuri Debevc.

23 More importantly, those companies were all funded
24 through the proceeds of the sale of customer stocks.
25 Customers didn't know that. Derivium Capital took nearly

1 \$45 million and stuck it into these companies, these
2 companies personally owned by the owners of Derivium, Robert
3 Nagy profited from these companies. Robert Nagy sat on the
4 advisory boards of numerous companies. Robert Nagy charged
5 all of these companies. He profited from all of them from
6 different work he was doing.

7 He profited from C3, Scienda. He profited from
8 Charleston Aluminum. He profited from Charleston
9 Construction Company. He profited from this company right
10 here, Shenandoah, another shell company. Mr. Nagy wasn't
11 just doing work in the United States, because these were all
12 American companies, there were foreign companies involved,
13 too.

14 And Mr. Nagy was doing work for those companies,
15 too. He was doing work for a company, DDA, Diversified
16 Design Associates, a shell company in Ireland, and he was
17 getting paid from people at Derivium for a shell company in
18 Ireland. He was doing work for a company called Bancroft
19 Ventures, Ltd., an Isle of Man company. And you are going to
20 hear testimony from some of these directors, and I'm going to
21 talk a little bit about them more in a minute.

22 But they don't even know who Robert Nagy is, and he
23 was billing Bancroft. And guess who is paying his bills for
24 the work he is doing for Bancroft? Derivium Capital.

25 We are going to come back to this in a minute. I

1 also want to mention -- we are speaking about independence,
2 some of the inside information that Robert Nagy knew about
3 this scheme. Robert Nagy knew information that not even some
4 of Derivium's own employees knew. For example, some of the
5 marketing people of Derivium Capital didn't even know who the
6 lender was. For years, they didn't know the identity of the
7 lender. Robert Nagy knew from DDA initially, Diversified
8 Design Associates, Robert Nagy knew it was Bancroft Ventures,
9 Ltd. Robert Nagy didn't just know there wasn't a lender; he
10 helped form the new Bancroft, participated in its formation.
11 Robert Nagy knew that the stock was sold. He knew that it
12 was sold before the transaction ever began. He knew it was
13 sold before customers ever got a penny. Customers didn't
14 know that.

15 Robert Nagy knew that there were no hedges. Robert
16 Nagy had access to the books of Derivium. He had access to
17 the books of that shell company, Bancroft Ventures Ltd., as
18 they were kept here in the United States.

19 He got a chance to look at those books and he saw
20 that not one penny was spent on hedges, on anything that
21 could protect a customer, that could protect a customer to
22 ensure that they would get their stock back.

23 Ladies and gentlemen, guess what happened when some
24 customers' stocks eventually went up, as was inevitable,
25 guess what happened? The evidence will show those customers

1 came back and they asked for their stock back. Hey, great
2 news, my stock has skyrocketed, I would like my stock back,
3 please, here's my money.

4 What do you think Derivium did? They didn't give it
5 back. They didn't give it back because they couldn't. There
6 were no hedges in place. They didn't have stock; it was
7 sold. They had no way to give that stock back to customers.
8 Robert Nagy knew that.

9 And how did Derivium Capital attract customers?
10 They placed ads in international publications, *Investors*
11 *Business Daily*, *Forbes* and the *Wall Street Journal*. Let's
12 take a look at an ad they ran.

13 Y'all have monitors there?

14 THE COURT: No.

15 MR. CLUKEY: So here we see an ad, go down to the
16 bottom there. If we blow that up. Derivium Capital. There
17 is the logo of the company, okay?

18 If we go down now to the bottom of the page,
19 there is a name and a number there. There is a name for that
20 thing, it's called a Bates number. It's used in litigation.
21 And that Bates number, Nagy_09 with the rest of that number,
22 that indicates that this document came out of the files of
23 Robert Nagy.

24 Okay. If we can go up to the image itself. You see
25 we've got a fish here, it's about to eat something. It's

1 pretty funny. The fish is made up of words. What's it about
2 to eat? Beware of the tax money. If you go back to the
3 fish -- and we look in some of the language there, you are
4 told, customers are told, you might be tempted to sell your
5 stock; instead, suggest using their 90% Stock Loan. Don't
6 sell your stock, use the 90% Stock Loan.

7 If we go down a bit more. If a customer is
8 intrigued by this and, what can they do? They can go and
9 call 888-Derivium. They can do that. If they did, Derivium
10 would send out marketing materials, a marketing package,
11 further information so they could followup and rope them in,
12 or you can go to derivium.com.

13 What happens if you go to derivium.com? Let's take
14 a look. Right here we see -- we've got a page we can blow
15 up. Right there we've got the Derivium Capital logo again.
16 If we go up to the top of the page, and we see here we've got
17 the web address up at the top, derivium.com, and the welcome
18 page here. We go down to the bottom. Again, we've got that
19 Bates number, that number telling us that this document came
20 out of the files of Robert Nagy.

21 Down at the bottom of this welcome page, this is the
22 last text box here, it says, Welcome to Derivium, read on to
23 show you what you can do when you open the box. So let's
24 read on.

25 Here we have the services page. And here you are

1 being told this is a real loan, 90% Stock Loan. There is
2 different benefits and features of this stock loan. One of
3 the objectives that customers are told they should have is
4 capital gains tax deferral, tax free while you are in this
5 transaction. Capital gains tax. Taxes on your stock. You
6 are not going to have to pay any capital gains taxes now.
7 Those will be pushed off into the future, not with this
8 transaction.

9 Go down to the futures and benefits. And here
10 again, they are talking about the tax benefits. And I would
11 like to read that: "Features and benefits. You don't have
12 to sell your shares and trigger a tax liability because loans
13 are not taxable events. In fact, depending on your
14 individual tax situation, our structure may even enable you
15 to generate more cash than selling the position outright.
16 Net of capital gains tax liabilities."

17 Okay. Now, I've already told you the only person
18 who would tell Derivium Capital in writing that this program
19 was a real loan under the tax laws, the only person who could
20 do that was Robert Nagy.

21 Let's take a look at one of the memos that he wrote.
22 Here we go. If you can blow up the top there, this memo,
23 Robert J. Nagy, Certified Public Accountant, and we see it's
24 dated June 8th. He's writing a memo to Dr. Charles Cathcart
25 and Derivium Capital, LLC. So let's go down to some of the

1 text.

2 And this is what he's telling this memo is about.

3 "Gentlemen, you've asked that I address certain tax
4 considerations of the Derivium 90% Stock Loan." And he says:
5 "This memo is intended to provide an overview of the tax
6 considerations which may be helpful when discussing a
7 Derivium loan with a potential client for their tax advisor."

8 So he's telling you here this memo and this advice
9 can be used when you are talking to a potential client.

10 If we read on, Robert Nagy tells Derivium, he tells
11 customers that Derivium is going to provide custodial
12 services for the collateral security.

13 So for the stock, he's telling you, stock is going
14 to be collateral. And you read on. And so Derivium, as
15 custodian of the collateral, they are going to effect hedges,
16 hedges to protect the stock.

17 And we go on to the next page. And his tax
18 considerations that he's telling people about, the principal
19 tax consideration discussed below is whether the transaction
20 is a loan, thereby being a nontaxable event, or whether it
21 should be viewed as a constructive sale.

22 Ladies and gentlemen, you've already heard me say
23 this Court has ruled that it was a sale; it was not a loan.
24 The statements claiming that it was a loan, those were false.
25 And this memo, in the end, Robert Nagy concludes this is a

1 loan. Those statements were false.

2 So ladies and gentlemen, after you investigate all
3 of the evidence, what are we going to ask you to decide? You
4 were just told by Judge Norton, you are going to be asked to
5 decide whether Robert Nagy should have penalties imposed
6 against him for violation of a particular law. That law, as
7 Judge Norton told you, is 6700 USC -- I'm sorry -- 26, USC,
8 Section 6700.

9 And the Judge, Judge Norton, at the end of the
10 trial, he can tell you exactly what that law means and what
11 has to be shown under the law. But in its broadest sense,
12 that law prohibits people from making false statements, false
13 or fraudulent statements regarding the tax benefits of a plan
14 that's marketed to the public.

15 Now, the Court's already ruled claiming this is a
16 real loan, those are false statements, so you don't have to
17 decide that part. What you are going to have to decide is
18 whether Robert Nagy knew or had reason to know that the
19 statements he was making were false or fraudulent.

20 Judge Norton also just told you the United States
21 has the burden of proof here. And he told you that this
22 isn't a criminal case, it's a civil case, so it's got a
23 different standard of proof.

24 The United States has to prove its case by a
25 preponderance of the evidence. And Judge Norton said that

1 means something. The preponderance of the evidence means
2 something is more likely true than not. And I think he used
3 the analogy of the scale. Put all the evidence on the scale,
4 if it tips just ever so slightly in the Government's favor,
5 that means the Government has proved its case by a
6 preponderance of the evidence.

7 I think about it in football terms. What that means
8 is he doesn't have to score a touchdown, we don't have to
9 fall in the end zone, all we have to do is cross the 50-yard
10 line.

11 The Government in this case is represented by three
12 lawyers, and Judge Norton just introduced me, and we met, in
13 a sense, when you were selected to be jurors in this case
14 nearly two months ago.

15 Just to remind you, my name is Nathan Clukey. You
16 also met my cocounsel Ellen Weis, and I would like to
17 introduce you to Greg Seador, he's also with the Department
18 of Justice. And I also want to introduce you to Sam
19 Sullivan, he's also with the Department of Justice, but he's
20 an IT specialist. He's going to help us with exhibits and
21 electronics during the course of the trial.

22 Now, ladies and gentlemen, the types of evidence you
23 are going to be asked to consider as detectives, basically in
24 two categories, documents and testimony.

25 Now, you've just seen a couple of documents, and

1 there is going to be a lot of them, I warn you. And you are
2 also going to hear testimony, testimony from people like the
3 first one I just mentioned, Professor Paul Pfeiffer from the
4 United States.

5 You are also going to hear testimony from Boyd
6 Strickland. Boyd Strickland is an expert hired by the
7 Government. Boyd Strickland was a local guy, born in
8 Charleston, born and raised here. He is a certified fraud
9 examiner, and he's also a CPA, Certified Public Accountant.
10 We asked Lloyd to look at the books and records of Derivium
11 Capital, the books and records that Robert Nagy had access
12 to. We asked him to look at all those records and see what
13 he thought.

14 And he did that. And he'll tell you that when he
15 looked at the books and records, not one penny was spent on
16 hedges. He looked at the same books and records that Robert
17 Nagy had access to, no money was found on hedges. He is also
18 going to tell you that the way Derivium kept its books and
19 records, it did it in such a way as to hide what was really
20 going on with this transaction.

21 So if a third-party ever came in, they wouldn't know
22 what was going on. And Roy Strickland is going to tell you
23 that that money, that \$45 million was funneled from the sale
24 of customers' stock. It was funneled from the customers that
25 owned Derivium Capital. Those companies on which Robert Nagy

1 sat on the advisory boards for, from companies which Robert
2 Nagy profited from doing all kinds of work. He's going to
3 tell you that, too.

4 Ladies and gentlemen, you are also going to see
5 evidence in this case that there were no lenders, no real
6 lenders. And I'll bring up this board here again for just a
7 second.

8 I'm going to talk about just three of these
9 companies on here real quickly. Start with that first one,
10 Diversified Design Associates, DDA in Ireland. DDA in
11 Ireland, they didn't do anything. It was a shell company.
12 They didn't do anything. They didn't have to.

13 You are going to hear testimony from a guy named
14 Jerry Pryor who is also a local guy. Jerry Pryor got mixed
15 up in this scheme early on, '97, and got out, but he saw what
16 was really happening from the very beginning.

17 Customers would turn their stock over to Derivium
18 Capital, supposedly as collateral. Derivium just sold the
19 stock, took the money, gave it back to customers. The
20 customer kept ten percent. He's going to tell you there was
21 no DDA that actually did anything because DDA didn't have to
22 do anything, they didn't need a real lender.

23 You are also going to hear testimony about a company
24 called Bancroft Ventures Ltd. in the Isle of Man, another
25 shell company, another company that didn't do anything.

1 You are going to hear testimony from a guy named
2 Colin Bowen and Nigel Wood. They were directors at Bancroft.
3 They existed, the company existed, but it didn't do anything,
4 and they are going to tell you that. They are going to tell
5 you they didn't do any loans. They are going to tell you
6 they didn't do anything real, anything substantive like a
7 real bank or a real lender would do. They are going to tell
8 you they didn't have any reserves for money, they didn't have
9 any reserves over there. They didn't do any underwriting,
10 didn't approve any loans, didn't interact with customers.
11 They didn't talk to customers. They didn't see the stock.
12 The stock never went to them. Everything happened right
13 here, Derivium Capital. In short, they are going to tell you
14 it was a shell company.

15 Now, I need to warn you, their testimony is going to
16 be by video and by written transcript, and there is going to
17 be other testimony in this case just like that.

18 Now, you need to know that that doesn't mean their
19 testimony isn't as important as any of the live testimony
20 that you are going to hear. It's just as important, but the
21 parties here can't force people who live far away to come
22 here. You can't do it. Even the Government can't do that.
23 And since these folks live in the Isle of Man, a country off
24 the Coast of Ireland, a country I had to look up on a map
25 when I first started this case, they obviously aren't close

1 by and we couldn't force them to be here.

2 You are also going to hear testimony about a company
3 called Optech, another shell company just like DDA, just like
4 BVL, a company in Hong Kong. And you will hear testimony
5 from a gentleman named James Sutherland. And he's going to
6 tell you -- he's also go to testify by video because he's in
7 Hong Kong -- we had to fly to Hong Kong to depose him and
8 track him down -- he's going to tell you Optech didn't do
9 anything as a real lender. The scheme worked the same way,
10 stock came in, sold the stock, gave the proceeds back to the
11 customer, kept ten percent.

12 And you might hear talk in this case about an IRS
13 audit that took place at Derivium Capital, an audit that
14 concluded in 2003. And if you do, you are also going to see
15 evidence that the IRS was deceived, that the misstatements
16 were made to the IRS -- false statements were made to the
17 IRS, and those false statements were made by Robert Nagy.

18 You are also going to hear about an investigation by
19 the California Franchise Tax Board. And what is that? It's
20 the largest state taxing authority in the country.

21 In 2004, February of 2004, the California Franchise
22 Tax Board told Derivium -- Robert Nagy knows this -- told
23 Derivium that it thought the scheme was a tax shelter, a
24 scam, didn't work under the tax laws. That didn't stop
25 Robert Nagy. That didn't stop Derivium. They kept on

1 promoting the scheme.

2 That same year, the IRS came back and told Robert
3 Nagy, told Derivium Capital, that this scheme violates the
4 tax laws. Didn't stop them. Kept on promoting this scheme.

5 In fact, after the IRS was -- after the IRS told
6 them -- told Derivium that this thing was a scam, in 2004
7 Robert Nagy writes another tax memo in 2005 telling the
8 customers, here is more general tax advice about how the
9 scheme works. Do you think he put in that memo the fact that
10 the IRS has now challenged this thing? Do you think that was
11 in there? The evidence will show it was not.

12 I want to discuss one last thing, one last thing
13 that Robert Nagy was doing while he was providing these tax
14 memos, writing these tax memos. And you might see a chart --
15 I don't know if you are going to see this or not, you might,
16 that Mr. Cooper prepared -- and this chart, it's nice looking
17 and it's got some of the tax memos that Robert Nagy wrote
18 over the years.

19 It starts in 1998, '99, goes on through the years.
20 It's actually got images of the tax memos, includes in 2005,
21 that 2005 memo I just told you about, it doesn't tell
22 customers that the IRS thinks this is a sham.

23 Well, one other thing to think about if you see that
24 chart is that 1998, when Robert Nagy is writing his '98 memo,
25 he didn't pay his taxes that year. He didn't pay them.

1 Y'all know you have to pay your taxes when they are due.

2 Everyone knows that.

3 Robert Nagy is an accountant. In 1999, he doesn't
4 pay his taxes. Another memo, 2000. Another memo, doesn't
5 pay his taxes. 2001, doesn't pay his own taxes, his own
6 personal income taxes. 2002, doesn't pay his own taxes. He
7 doesn't pay those taxes until 2005.

8 Ladies and gentlemen, so think about that. If you
9 are shown that chart, you think about what Robert Nagy knew
10 and what he had reason to know during the existence of the
11 scheme.

12 Ladies and gentlemen, ultimately over the course of
13 more than eight years, Derivium Capital and these companies
14 caused the sale of more than one billion dollars of its
15 customers' stocks, all the while Derivium Capital falsely
16 told customers, and Robert Nagy falsely told customers that
17 this was a real loan, customer stocks would be collateral,
18 and that this transaction would be tax free, get the tax
19 deferral, no capital gains taxes, that real lenders were
20 involved, and that hedges would be in place to protect
21 customers, ensure the customers would get their stock back.

22 Ladies and gentlemen, the United States contends
23 those statements were false and fraudulent, and that Robert
24 Nagy knew or had reason to know that those statements were
25 false or fraudulent.

1 Thank you for your attention and your hard work to
2 follow.

3 THE COURT: Thank you, Mr. Clukey.

4 Yes, sir. Mr. Cooper?

5 MR. COOPER: May I begin, Your Honor?

6 THE COURT: You sure can.

7 MR. COOPER: My name is Lindsey Cooper. I'm a
8 lawyer here in Charleston. I practice down on Broad Street,
9 and I'll be talking to y'all.

10 This man here is my client, Robert J. Nagy. Sitting
11 next to him is Erica Vann, she's a paralegal in my office and
12 we will be sitting at that table and talking to you today and
13 in the coming days.

14 This case is about tax advice. As he talked about,
15 it's about the tax advice that Robert J. Nagy gave to his
16 client. This is a case whether Mr. Nagy, when he gave that
17 advice at the time, he knew or had reason to know it was
18 false and fraudulent.

19 That man there is going to get on the stand and he's
20 going to tell you he believed it was right. He's going to
21 tell you what he did in coming to that conclusion, and he's
22 going to tell you why he did not make a false or fraudulent
23 statement.

24 Now, I'm going to give you an example. A father and
25 son sit on the couch in the evening in the living room

1 watching TV. The son comes in every night with a glass of
2 grape juice and they sit there and drink grape juice with his
3 father and watch TV. The days go by. The weeks go by. The
4 months go by and the father doesn't say anything about
5 drinking grape juice.

6 Then one day the father realizes if he spills that,
7 he's going to stain the carpet. And he says, you cannot do
8 that anymore, and he punishes them for all those months. The
9 story you are going to hear is the same kind of punishment
10 Mr. Nagy received.

11 In 2001, the IRS initiated an audit of Derivium
12 Capital. The IRS agent in town, Neva Gadsden, is a CPA like
13 Mr. Nagy. At the end of the audit, the IRS issued a
14 no-change letter. Mr. Nagy is going to tell you he believed
15 his position was correct.

16 Now, let me introduce my client. My client
17 graduated from the University of South Carolina in 1972.
18 During college, he was with the Reserves with the U.S. Air
19 Force. He went and served two years of active duty, came
20 back in 1974 to Columbia, South Carolina and started
21 practicing as a CPA when he got his license.

22 He was subsequently honorably discharged from the
23 Air Force and started his family with that lady there. She
24 has been his wife for 39 years. They have three children,
25 Robert Nagy, Jr., English Preston, who is married to a

1 professor at the Citadel, and a younger daughter, Sarah Nagy.
2 He's also a grandfather. Mr. Nagy is a CPA. He's a solo
3 practitioner here in Charleston and he does provide tax
4 advice to his clients, and he did provide tax advice to
5 Derivium Capital.

6 Derivium Capital, it had its own employees. It
7 wasn't just Mr. Nagy; Derivium Capital had an internal CPA.
8 Derivium Capital also had bookkeepers. Mr. Nagy was the
9 outside tax advisor. Derivium Capital has its own internal
10 employees. And they will tell you they didn't suspect
11 anything was wrong, but somehow the Government expects you to
12 think that Mr. Nagy expected that.

13 The third person in this cast of characters is the
14 IRS. And what happened? Now, also there are two categories
15 of statements that were talked about. One is tax advice,
16 that's what we'll be focused on; two is the hedging strategy.

17 So let's start with the tax advice. This is the
18 memorandum timeline. And Mr. Nagy provided his advice not in
19 a vacuum, but it was over a continuum of time. So when you
20 think about time, think about when the statements were made
21 and what was happening.

22 His first advice was in 1998. As you go down the
23 timeline, the IRS started its audit in November of 2001. The
24 audit no-change letters were then issued in May and June of
25 2003. Mr. Nagy had provided almost all of its advice before

1 the IRS issued the no-change letters.

2 There were two subsequent memos to that. There was
3 an April 2004 memo, which was a memo that Mr. Nagy wrote to
4 Derivium as a defense paper to the California Franchise Tax
5 Board. This was their business. They weren't just going to
6 roll over. They believed it was a loan. They fought it.

7 The second memo was January 2005 and at that time
8 the IRS had started auditing the transaction, which was two
9 years after the no-change letters. Again, the memorandum was
10 written to fight the IRS's position. Just because the IRS
11 says something is right doesn't mean it's right.

12 Now, I do want to show you a piece of his tax
13 memorandum. And this is the memorandum written on
14 September 29th. Here at the very beginning, he writes a
15 disclaimer at the beginning of these memos, and he tells
16 Derivium, I specifically disclaim any responsibility for
17 providing tax advice, and I disclaim any tax advice that your
18 clients might rely on. Those clients didn't hire Mr. Nagy,
19 he disclaimed it.

20 Then at the back of the memorandum -- he didn't hide
21 anything -- in the conclusion, you see that word "however".
22 However, the IRS may challenge it. He's telling his client,
23 yeah, the IRS may change its mind. These were fully
24 disclosed. And in his tax memoranda, he sets forth, while
25 certain details may vary, this is my understanding of the

1 transaction. And as you see, and Mr. Nagy will testify, he
2 goes through page and page, cites law, cites the Internal
3 Revenue Code Section 2059. He was providing support for his
4 opinions.

5 Also, in 2001 you will see that Mr. Nagy received a
6 memorandum from the law firm of McDermott Will & Emery. It's
7 a very big law firm. They wrote this memorandum on a 90%
8 Stock Loan. And you will see the work that Mr. Nagy did and
9 the work that they did were similar. He believed his advice
10 was good.

11 Now let's talk about how the stock loan worked. If
12 a client came in, they signed a loan document. It says:
13 Loan Document. The collateral was the stock. I give you
14 \$100 worth of stock; they gave back \$90. There was an
15 interest rate associated with it. There was a maturity date
16 associated with it. And the document created an
17 unconditional obligation to repay. That's why those
18 borrowers wanted it back because of the unconditional
19 obligation to repay it. This document looked like a loan
20 document and the amount of the loan was less than the value
21 of the stock.

22 You heard about this court, and His Honor on the
23 bench, he ruled that it was a loan.

24 When did he rule? December --

25 MR. CLUKEY: Objection, Your Honor.

1 THE COURT: You said I ruled it was a loan.

2 MR. COOPER: I'm sorry. I wish he ruled it was a
3 loan.

4 THE COURT: Okay.

5 MR. COOPER: He ruled it was a sale. The date of
6 the ruling was December, 2009. That's not even on my
7 timeline. From 1998 to 2009, Mr. Nagy will testify to you
8 that he knew of no tax court case, federal case or any IRS
9 issuance that said this transaction was a loan. Here is
10 where the IRS comes into the story.

11 In 2001, Neva Gadsden opened an audit. And during
12 the audit, she first met Mr. Nagy on December 4th. And why
13 does she meet with Mr. Nagy? Derivium hired Mr. Nagy to be
14 what is called his power of attorney. That means Mr. Nagy
15 was representing Derivium during the audit.

16 Information went through him from his client to the
17 IRS and back. He first met with Ms. Gadsden in December of
18 '04. And he sat down with her and he told her Derivium's
19 business was stock loans. He gave her the general ledgers of
20 the company showing the stock loans. He discussed with her
21 the mechanics of the transactions that I discussed with you.
22 He gave to her the loan document, that marketing material you
23 saw on the screen.

24 It was in Mr. Nagy's file because he gave it to the
25 IRS because Mr. Nagy disclosed the stock loan. Ms. Gadsden

1 went out, and a woman named Mary Socks, who was also an IRS
2 agent, joined the audit. Her title is called Financial
3 Products Specialist. She deals with complex transactions.
4 Mr. Nagy also told Ms. Gadsden that there was that foreign
5 lender.

6 So who else joined the audit? Mr. Guida, IRS agent,
7 international examiner. All of these folks sent something
8 called an information document request to Derivium through
9 Mr. Nagy. This is the information document request sent from
10 Ms. Socks to Mr. Nagy.

11 Ms. Socks is the Financial Products Specialist,
12 scroll back up, please. No, this is not right. This is the
13 IDR sent from Ms. Socks to Mr. Nagy. Subject. See at the
14 top? Loans and hedging activities. 17 categories of
15 information requests were sent through, submitted to Robert
16 J. Nagy.

17 Number two, explain your hedging activities.

18 Number nine, give me your promotional materials.

19 Number seven, describe hedging activities.

20 Mr. Nagy responded throughout the audit. Ms.
21 Gadsden will tell you Mr. Nagy was cooperative; to the best
22 of her knowledge provided all information that was requested.

23 And the sale of the stock that they were talking
24 about, he told the IRS that the lender sold the stock. He
25 didn't tell them just once.

1 Number seven, all collateral securities were sold is
2 the first part of the hedging activity.

3 At the same time this audit is going on, the IRS
4 audited Scott Cathcart, the owner of Derivium. Do you know
5 how many stock loans that he did during the year 2000, the
6 year they were auditing? Don't even have enough fingers.
7 Eleven. I'll put the pencil up. Eleven. Those stock loans
8 were in excess of a million dollars.

9 Mr. Cathcart took a \$150,000 investment interest
10 expense on his tax return related to the Derivium stock
11 loans. It was written on the tax return. And Neva Gadsden
12 was auditing him, too, with the same type of financial
13 products specialists. Do you know what happened? Both
14 examinations to Derivium, to Scott Cathcart, and the IRS no
15 changed both of them.

16 1998, no change. Derivium, Scott Cathcart, 2000 tax
17 year, no change. Did the IRS ever breathe a word of bad
18 conduct to him, Mr. Nagy? No. Mr. Nagy believed it was a
19 loan.

20 After those letters were sent in 2003, Mr. Nagy was
21 assessed by the IRS for allegedly promoting this stock loan.
22 That assessment was made in January, 2008. And the penalties
23 are from 1998 to 2005. So they are trying to penalize him
24 even after the no-change letters were sent in 2003.

25 Let's talk about the hedges. And when we talk about

1 hedges, it's just basically a way to pull that collateral
2 back. And it's complicated stuff. Puts and calls,
3 derivatives. Mr. Nagy does not have a Ph.D. in economics.
4 Mr. Nagy has not written textbooks on economics. Mr. Nagy
5 has no experience trading on Wall Street.

6 Who had this experience? Doctor Cathcart, Vice
7 President of Citibank. Dr. Cathcart, Ph.D. in economics.
8 Dr. Cathcart wrote on economics. Dr. Cathcart taught at the
9 Charleston College. Dr. Cathcart worked for public companies
10 managing their risk.

11 Dr. Cathcart was the one that was supposed to be
12 doing the hedging; not Mr. Nagy. And Dr. Cathcart, he told
13 the world there were hedges. Those same promotional
14 materials, Charles Cathcart has a Coca-Cola syrup formula for
15 hedging portfolio concentration listing. That's what he told
16 my client.

17 My client did at one point have access to Derivium's
18 books and records because they have the brokerage accountant
19 statements for the lenders. He didn't see hedging. He
20 thought what he did what was right. He went to Robert
21 Brandenburg, where are the hedges? Mr. Brandenburg said, you
22 won't see any of those in the house.

23 He went to Tim Scrantom, Mr. Nagy will tell you, and
24 said, where are the hedges? Mr. Scrantom, who was Derivium's
25 lawyer said, I don't know.

POLK - DIRECT

1 Mr. Nagy then went to the horse's mouth, Charles
2 Cathcart. Mr. Cathcart told him the lender was doing them
3 offshore, and Mr. Cathcart was very secretive about his
4 hedging strategy. And there is no denying Dr. Cathcart makes
5 stupid decisions, but Mr. Nagy did not know about them.

6 When we get done here, I'm going to ask you to find,
7 based upon what is brought into evidence, that Mr. Nagy did
8 not have the state of mind, he did not know. He had no
9 reason to know his tax advice was false.

10 Thank you.

11 THE COURT: Yes, sir, Mr. Clukey? Do you want to
12 call your first witness?

13 MR. CLUKEY: Yes, Your Honor. For its first
14 witness, the United States calls Mr. Ken Polk.

15 THE CLERK: Right here, Mr. Polk. Place your left
16 hand on the Bible.

17 State your name for the record.

18 THE WITNESS: Kenneth Howell Polk.

19 THE CLERK: Thank you. Be seated on the witness
20 stand.

21 THEREUPON:

22 MR. KENNETH POLK,
23 Called in these proceedings and having been first duly sworn
24 testifies as follows:

25 DIRECT EXAMINATION

POLK - DIRECT

1 BY MR. SEADOR:

2 Q. Good morning, Mr. Polk.

3 A. Good morning.

4 Q. Can you please tell us your full name?

5 A. Kenneth Polk.

6 Q. Where are you from?

7 A. Birmingham, Alabama.

8 Q. What do you do for a living?

9 A. I'm a financial advisor.

10 Q. Can you briefly describe for the jury your educational
11 background?

12 A. I am a CPA. I graduated from high school in 1990, and
13 then from Lipscomb University in 1994 out of Nashville,
14 returned to Birmingham and worked for Deloitte & Touche and
15 got my CPA license.

16 Q. Have you got any professional licensures?

17 A. Yes. I'm a Certified Financial Planner, also.

18 Q. You mentioned you worked for a period for Deloitte &
19 Touche. What did you do after you left that firm?

20 A. In January of 1998, having been at Deloitte & Touche for
21 approximately two years, I started Arlington Partners, which
22 is a financial services firm.

23 Q. And before we get to Arlington partners, what did you do
24 at Deloitte & Touche? What did you do there?

25 A. I was a tax consultant.

1 Q. What are your duties now that you formed Arlington
2 Partners?

3 A. I'm a CEO of Arlington.

4 Q. Can you give the jury some examples of what you do from
5 day-to-day for your clients?

6 A. Most of the time the families that we serve will have a
7 liquidity event where they sell a business and then have --
8 have capital or money from that transaction and we'll help
9 them from taxes to investments to any type of planning that
10 they need in their situation.

11 Q. Are you familiar with something called a 90% Stock Loan?

12 A. Yes.

13 Q. And can you tell us how you were introduced to that?

14 A. The first time was just through a publication that I saw
15 the advertisement.

16 Q. Did you do anything after you saw the publication?

17 A. Not initially. I had seen one and then I saw that one
18 later on, which had me contact Derivium.

19 Q. You called them?

20 A. Yes.

21 Q. And what, if anything -- did they send you anything when
22 you called?

23 A. They did. They inquired about our firm and then they
24 sent a package of information.

25 Q. Okay. And did you review that?

1 A. I did.

2 Q. And what was your understanding of the 90% Stock Loan at
3 this time after you reviewed the marketing materials that
4 were sent to you?

5 A. The transaction like this is, that there are similar
6 transactions that we had entered into before with typical
7 Wall Street firms, so this transaction was similar in that
8 you had limited downside, which was the 90% you received
9 upfront. The difference in this one, in our experience, was
10 that it had unlimited outside potential.

11 Q. Can you explain what that means for the jury, "unlimited
12 upside"?

13 A. If you were to have a stock that doubled or tripled in
14 value, normally you wouldn't get to have all of that benefit.
15 And in this, the way it was explained to us in the materials
16 we received, it said that you could receive all of the upside
17 after you pay your interest on your loan.

18 Q. And let's talk about sort of the mechanics. What did you
19 understand the mechanics to be if you had a client that
20 wanted to actually enter into the transaction?

21 A. The client would transfer the money, um -- or I'm
22 sorry -- the stock, they would transfer their stock to a
23 financial organization, Wachovia, Morgan Keegan. And at that
24 time then they would hedge the stock and then send you
25 90 percent.

1 Q. What was your understanding of what the tax benefits of
2 the program were?

3 A. The tax benefits were that at the time of the sale, that
4 there were no -- there were no tax consequences at that time.

5 MR. SEADOR: Will you pull up Government Exhibit 38,
6 please?

7 May I approach the witness, Your Honor?

8 THE COURT: Sure.

9 Q. I've handed you what's been marked into evidence as
10 Government Exhibit 38.

11 Take a look at that for a minute. There's a number
12 of pages.

13 Do you recognize that?

14 A. I do.

15 Q. What is it?

16 A. It's a -- it's a package of information similar to the
17 one that I received.

18 Q. What sort of information is it?

19 A. A combination of letters that -- loan agreements and
20 different marketing materials.

21 Q. Okay. And you received something like that from
22 Derivium?

23 A. Yes.

24 Q. If you could turn to page 26 of that document -- and I've
25 got that page up on the screen here for the jury --

1 MR. SEADOR: Sam, if you could blow up the top half
2 of that.

3 Q. Are you with me, Mr. Polk?

4 A. Yeah.

5 Q. Okay. You see those bullet points on there on page 26 at
6 the top it says "90% Stock Loan Overview," and there are
7 several bullet points there.

8 Does that comport with your understanding of how the
9 program worked and the tax benefits that were supposedly
10 offered?

11 A. Yes.

12 Q. Now, once you received the marketing materials, what, if
13 anything else, did you do after that?

14 A. We entered into a period of due diligence.

15 Q. And can you just describe for the jury what you mean by
16 due diligence?

17 A. Our clients hire us to represent them.

18 So what we would do is get a list of references and
19 call those individuals and talk to individuals who had
20 participated in this same program.

21 Q. Did you do that?

22 A. Yes.

23 Q. And did you pose any additional questions to Derivium?

24 A. Yes. We came back to them and inquired just more about
25 the tax consequences; and also some of the references that we

1 received, we asked some questions.

2 Q. And when you were asking them those questions, did they
3 tell you that the stock was sold immediately?

4 A. No.

5 Q. Did they tell you there was no hedge?

6 A. No.

7 Q. And if they had told you those things, would you have
8 recommended to your clients that they enter into this
9 transaction?

10 A. No. Our specific question is, do you hedge? And the
11 answer was yes. And so we would not have done it if there
12 was not protection.

13 MR. SEADOR: Sam, can you pull up Exhibit 45 for me,
14 please?

15 May I approach again, Your Honor?

16 THE COURT: Sure.

17 Q. I am handing you what's been marked into evidence as
18 Government Exhibit 45. Just take a minute to look at that.

19 Do you recognize that document?

20 A. Yes.

21 Q. And what is it?

22 A. It's a memo discussing the tax consequences in the
23 Derivium transaction.

24 Q. Did you receive that document from Derivium?

25 A. Yes.

1 Q. Okay. And did you review that in connection with your
2 due diligence?

3 A. Yes. There was one. It's one of the items I requested.

4 Q. You see there on the first paragraph on the very first
5 page, it says, " This letter is an update from my previous
6 correspondence to provide the tax considerations discussed
7 herein which may be helpful when discussing a Derivium loan
8 for a potential client."

9 Did you find when you reviewed this document that it
10 was helpful?

11 A. Yes.

12 Q. And what was the primary thrust of the document, what did
13 it talk about?

14 A. The document just summarized the reasons why you would
15 not have to pay taxes if you were to enter into this
16 transaction.

17 Q. And did it tell you, this memo from this accountant, Mr.
18 Nagy, to tell you that the stock was immediately sold upon
19 receipt?

20 A. No.

21 Q. Did it tell you that there were no hedges to protect the
22 stock?

23 A. No.

24 Q. If it had told you those things, would you have entered
25 into this transaction?

1 A. Absolutely not.

2 Q. Now, after receiving Mr. Nagy's memo and conducting your
3 due diligence, did you, in fact, have clients that entered
4 into a 90% Stock Loan?

5 A. We did.

6 Q. And approximately how many?

7 A. Approximately eight.

8 Q. Okay. And I wonder if you could describe what your role
9 was vis-à-vis Derivium and your clients, what did you do?
10 Did you coordinate? How did you --

11 A. We would, um, give our clients different options. We
12 would let them look at the Derivium transaction and other
13 Wall Street options that were similar and then work with them
14 on which one they wanted to use, help them make a choice.

15 Q. And documents that needed to be completed by your clients
16 in order to enter into the 90% Stock Loan transaction, did
17 they come through you first?

18 A. They did.

19 Q. Okay.

20 MR. SEADOR: If you could pull up Government
21 Exhibit 237, please.

22 Can I approach, Your Honor?

23 THE COURT: Sure.

24 Q. I've given you what's been marked for identification as
25 Government Exhibit 237.

1 Do you recognize that document?

2 A. Yes.

3 Q. Can you tell us what it is?

4 A. It's a document related to one of our clients related to
5 the transaction.

6 Q. If you flip to the second page, the signature -- maybe
7 it's the third page. Go one more. Yeah.

8 Q. There at the bottom, the signature, John R. Moody. Do
9 you know who that is?

10 A. Yes.

11 Q. Who is it?

12 A. A partner.

13 Q. And did you maintain a copy of this document in your
14 files?

15 A. Yes.

16 Q. And you received a subpoena from the Government in this
17 case, didn't you?

18 A. From?

19 Q. The U.S. Government?

20 A. In the -- I believe so -- in the Charles Cathcart matter,
21 yes.

22 Q. But in response to that subpoena, did you turn over all
23 the documents in your files related to the 90% Stock Loan?

24 A. Yes.

25 Q. And this was one of those?

1 A. Yes.

2 Q. And does this appear to be an accurate copy of the MLA
3 from Mr. Moody?

4 A. Yes.

5 MR. SEADOR: Your Honor, I move Exhibit 235 into
6 evidence, please.

7 MR. COOPER: No objection.

8 THE COURT: In evidence.

9 (Thereupon, Government Exhibit Number 235 was
10 received in evidence.)

11 Q. Now, did your client, Mr. Moody, enter into a 90% Stock
12 Loan transaction?

13 A. He did.

14 Q. And what do you understand the import of this document to
15 be between Mr. Moody and Derivium?

16 A. This is a Master Agreement, as it says at the top, a
17 financing or a loan agreement. It states the terms of which
18 they send you back the 90 percent, includes an interest rate
19 and a term of being three years of when the payment is due.

20 MR. SEADOR: If we could turn to Government
21 Exhibit 236, please? Can I approach, Your Honor?

22 THE COURT: Sure.

23 Q. I've handed you what's been marked for identification as
24 Exhibit 236.

25 Do you recognize that document?

1 A. Yes.

2 Q. Can you tell us what the first page of that is?

3 A. This is an evaluation confirmation. So when we entered
4 into a transaction, then Derivium would fax this or send us
5 this and say that the transaction is completed and they would
6 verify the price of the stock.

7 Q. Did you maintain that document in your files?

8 A. Yes.

9 Q. Did you turn that also over to the Government pursuant to
10 a subpoena?

11 A. Yes.

12 Q. And it appeared to be accurate?

13 A. Yes.

14 MR. SEADOR: I move this into evidence, Your Honor,
15 236.

16 MR. COOPER: No objection.

17 THE COURT: In evidence.

18 (Thereupon, Government Exhibit Number 236 was
19 received in evidence.)

20 Q. The name at the top of that document, John R. Moody, is
21 that the same Mr. Moody we saw on the previous document?

22 A. Yes.

23 Q. And can you tell us what information is conveyed on this
24 document?

25 A. The -- there is a part that says "SECURITIES RECEIVED,"

1 in all caps, and it says at Morgan Keegan. So that would be
2 the firm that held the stock. And then it also says Morgan
3 Keegan, the symbol RF, Regions Bank, and the number of
4 shares. And then it shows the total valuation of those
5 shares in the part that is highlighted.

6 Q. So if I understand what you are saying, your client,
7 Mr. Moody, transferred 45,000, or was going to transfer
8 shares of RF stock to Derivium?

9 A. That's correct.

10 Q. Okay.

11 MR. SEADOR: Can we blow that back up again?

12 If you could flip to the second page for me, next
13 page.

14 Can you tell us what that is?

15 A. This is a, what's called an activity confirmation that
16 confirms the hedge value of the stock.

17 Q. And when you say "the hedge value," you are referring to
18 that number there, 1,446,497?

19 A. Yes, where it says "securities hedged," it just gives a
20 summary of the hedge value.

21 Q. What did you understand that to mean, the hedged value?

22 A. It was protected or it was hedged.

23 Q. If you look down there towards the bottom, there is a
24 bold sentence, second one down, says "net due to client as a
25 result of hedging activities to date" and that's 1.3 million.

1 What did you understand that to mean?

2 A. That after the completion of the hedges, that we were to
3 receive the 90 percent, which was the million three.

4 Q. Does this document anywhere on here say that the stock
5 was being sold immediately to fund the loan?

6 A. No.

7 MR. SEADOR: Can I approach, Your Honor?

8 THE COURT: Sure.

9 Q. I've handed you what's been marked as Government
10 Exhibit 235 for identification.

11 Do you recognize that?

12 A. Yes.

13 Q. And can you tell us what that is?

14 A. It's a letter from Bancroft when the actual transactions
15 were -- the investor or someone who entered in to do the
16 transaction is going to be coming through.

17 Q. Let me just -- did you maintain that in your files?

18 A. Yes.

19 Q. And did you turn that over to the Government pursuant to
20 a subpoena?

21 A. I believe so.

22 Q. And does that appear to be an accurate copy of the
23 document?

24 MR. SEACORD: I would like to move that document in
25 at this time.

1 MR. COOPER: No objection.

2 THE COURT: In evidence.

3 (Thereupon, Government Exhibit Number 235 was
4 received in evidence.)

5 Q. That's Exhibit 235 for the record.

6 Now, from whom did you receive this particular
7 document, or documents like it?

8 A. From either Derivium or Bancroft.

9 Q. And at the time you received this, did you know who
10 Bancroft was?

11 A. I don't remember exactly when, but there was a point in
12 time where they entered into the transaction after we had
13 already entered into the loan agreement and got the hedge
14 confirmation.

15 Q. Did you try to find out who they were?

16 A. We did. We called the number that is listed on here on
17 the page, and we tried to contact them and did contact
18 Bancroft.

19 Q. Did it work?

20 A. Um, when we called the first time, they didn't even know
21 who Yuri Debevc was.

22 Q. What about Derivium?

23 A. The person who answered the phone first did not know who
24 it was and made a couple of comments that said we needed to
25 call back.

1 So we called back and that person initially said we
2 needed to talk to Charles Cathcart.

3 Q. Now, when you receive a letter like this, either from
4 Mr. Moody or from one of your other clients, does it lay out
5 some options for the client?

6 A. Yes.

7 Q. And what are those?

8 A. There were three options that I was aware of. One is
9 that if you have a loan, then you just pay the loan back and
10 get your stock back. So that would be one option, one of the
11 three options that I'm aware of. And then this letter
12 summarizes those options.

13 And the second one is you could renew it so you
14 could push the loan forward, so you just say, I want to renew
15 the loan and keep going forward, was the second option.

16 And the third option is just if the stock were to go
17 down, you just enter your collateral, you just walk away from
18 it.

19 Q. And did you have clients that exercised the first option?
20 In other words, their stock had gone up in value and they now
21 wanted it back?

22 A. Um, we never had any clients that wanted to pay. What
23 they wanted was really to surrender the collateral and get
24 excess back to them.

25 Q. Did you ever have any client that experienced the same

1 difficulty with their 90% loan transaction?

2 A. Yeah, there was, I believe in 2004.

3 Q. And can you describe what happened?

4 A. One of the first clients who entered into a transaction,
5 he was owed money, the stock had gone up significantly. And
6 so we immediately, you know, contacted Derivium to try to
7 figure out the best way to collect the excess collateral, and
8 that -- and to Derivium. And they said, okay, no problem.
9 We're still a couple of months out, let's wait until we get a
10 little bit closer.

11 So we got a little bit closer. We contacted them
12 again when the day passed where we were due the money, and
13 they kept putting it off and saying, well, it's very complex
14 hedges, and it's going to take a long time.

15 And so after about six months, we -- we got nervous
16 after about a month, but they were still kind of pushing it
17 along several months after this.

18 Q. Did they ever tell you during that point in time, gosh,
19 the reason we don't have the money is because we already sold
20 the stock and it was transferred to us?

21 A. No.

22 Q. Now, I wonder if you could tell us what impact did this
23 have on your clients that had engaged Derivium for this 90%
24 loan transaction? What happened --

25 MR. COOPER: Objection, 402, 403.

1 THE COURT: Rephrase that question, okay?

2 Q. Do you have any understanding of any consequences to your
3 clients from entering into a 90% Stock Loan transaction?

4 A. There were several. It was horrible. I'm their
5 fiduciary, so I had to go explain to them the whole thing was
6 a scam.

7 And then the other part was the very first person
8 who had collateral had bought a business, um, with that
9 money, and you know, he calculated t and he -- and it was
10 going in and sitting down with that person, and each of these
11 individuals, and explain to them that it was bad.

12 Q. And did that have any affect on your business?

13 MR. COOPER: Objection, 402, 403.

14 THE COURT: Sustain that.

15 Q. Did you have any understanding of what ultimately
16 happened to Derivium?

17 A. Nobody could -- we couldn't find out.

18 Q. Are you familiar with the term called qualified advisor?

19 A. Yes.

20 Q. And what's your understanding of that term?

21 A. That's what Arlington was. We were a qualified advisor,
22 which means that they send you a package of information to
23 review, a qualified group, in order to refer them, the
24 clients.

25 Q. That being Derivium?

1 A. Derivium.

2 Q. And do they promise you any -- did Derivium promise you
3 any referral fees for that service?

4 A. Yes.

5 Q. And do you recall how much that was per transaction?

6 A. Approximately one percent.

7 Q. One percent of the amount of stock?

8 A. The amount of stock.

9 Q. Okay. And what did you do with that money that you
10 received as a referral fee?

11 A. Rebated it back to our clients. We did accept it, but we
12 rebated it back to our clients.

13 Q. So you personally didn't make any money off of this?

14 A. No

15 Q. Just a couple more questions, Mr. Polk.

16 Did you ever ask anyone at Derivium what they were
17 doing with the stock when they received it?

18 A. Yes.

19 Q. Did you have an understanding of what it was?

20 A. Um, no.

21 Q. They just -- they just, what?

22 A. I specifically spoke with Charles, and that was -- that
23 was the secret source.

24 Q. They didn't tell you?

25 A. They didn't tell me.

1 Q. And did any of your clients that entered into this
2 transaction get their stock back?

3 A. No.

4 Q. You are from Alabama, you said that earlier?

5 A. Yes.

6 Q. Does your practice there keep you pretty busy?

7 A. Yes, very.

8 Q. Why did you take time out of your busy schedule to come
9 here to South Carolina to testify?

10 A. Because I promised each of those clients that I would.

11 MR. SEACORD: I don't have any further questions.

12 CROSS-EXAMINATION

13 BY MR. COOPER:

14 Q. You said you went to school at David Lipscomb?

15 A. I did.

16 Q. I'm from Nashville.

17 Exhibit 45 that was shown to you, the letter, Mr.
18 Nagy's letter, do you have that?

19 A. Yes.

20 Q. Did Mr. Nagy send that letter to you?

21 A. No.

22 Q. And do you remember Exhibit 38, which was what you said
23 was the promotional materials for Derivium?

24 A. Yes.

25 Q. Did Mr. Nagy send those to you?

1 A. No.

2 Q. And the letter from Mr. Nagy was only sent to you when
3 you specifically asked for it, correct?

4 A. That's correct.

5 Q. So it wasn't in that standard promotional materials,
6 right?

7 A. I don't recall actually if it was in the original
8 package. I do not recall that.

9 Q. But you recall specifically asking for some type of
10 letter about the tax consequences?

11 A. That was one of our due diligence items.

12 Q. You are a CPA; that's correct?

13 A. That's correct.

14 Q. You are also a Certified Financial Planner, correct?

15 A. That's correct.

16 Q. And you said while you were at Deloitte you were in the
17 tax practice?

18 A. That's correct.

19 Q. And at Arlington Partners, when you said you represent
20 family, you actually have a family office, right?

21 A. That's correct.

22 Q. And in family offices you represent very wealthy
23 families, correct?

24 A. That's correct.

25 Q. And in fact, they hire you because you are supposed to do

1 the due diligence, right?

2 A. That's correct.

3 Q. And your reputation is staked on your ability, your
4 office's ability to do due diligence, right?

5 A. Correct.

6 Q. Now, in Exhibit 38 that was sent to you -- and there is
7 no Bates stamp number, so I'll -- did Derivium disclaim in
8 the promotional materials that it didn't provide tax advice?

9 A. Yes.

10 Q. And on the next page they again disclaim they didn't
11 provide tax advice, correct?

12 A. Correct.

13 Q. Do you at Arlington Partners provide tax advice to your
14 clients?

15 A. Yes.

16 Q. Right.

17 And in fact, if we look at your website that I
18 printed out for Arlington Partners, on the second page, you
19 actually say the taxes have a large impact on the ultimate
20 success of wealth. "Arlington Associates provides the
21 resources to deliver tax integration and planning across the
22 family office".

23 A. Right.

24 Q. Would you agree that tax is a significant asset to your
25 clients?

1 A. Correct.

2 Q. And you are a CPA, correct?

3 A. Correct.

4 Q. How many other CPA's in your firm?

5 A. I believe nine.

6 Q. Nine?

7 So when you got Mr. Nagy's opinion, did y'all
8 research what he wrote in there?

9 A. Yes.

10 Q. How much time did you spend on that?

11 A. I don't recall.

12 Q. How many people researched it?

13 A. Probably two at that time. When we did it, we only had
14 six people in our firm.

15 Q. But there was enough research done to comfort yourself
16 that there was support for the tax treatment as a loan?

17 A. I'm not sure.

18 Q. So you are not sure. You would advise clients to do a
19 tax transaction that you weren't sure about?

20 A. No, we -- I mean, every document that there is out there
21 from the third-party, from our attorney, it says -- there is
22 always these, well, you can't rely on this. So there is --
23 we had the same disclaimer to our families that we represent.

24 Q. But what I'm saying is: You at Arlington Partners, you
25 said you think two people researched whether this was a loan

1 or sale under the Internal Revenue Guide?

2 A. Yes.

3 Q. And the question is: Did you come to the conclusion that
4 it was a loan?

5 A. We came to the conclusion that the facts in the memo we
6 received were reasonable.

7 Q. Did you know any facts that would have been inconsistent
8 with the memo?

9 A. I do not.

10 Q. And again, you wouldn't have referred your client to do a
11 transaction if you believed it wouldn't have held up at the
12 IRS, correct?

13 A. Correct.

14 Q. Because you wouldn't expose your clients to that kind of
15 risk with the IRS, would you?

16 A. No.

17 Q. And in fact, at the end of the memo that Mr. Nagy wrote,
18 do you -- you just talked about your lawyers say disclaim
19 everything, right?

20 You've got to answer. She's taking it down on
21 paper.

22 A. What's that?

23 Q. You have to --

24 A. I'm sorry. Excuse me.

25 Q. You have to answer the question.

1 A. What was the question?

2 Q. Do your lawyers tell you that you need to disclaim the
3 advice you give your clients?

4 A. No.

5 Q. Okay. You said disclaimers are -- lawyers, when they
6 write stuff, they put disclaimers on it?

7 A. No. I said if every document, every memo or anything you
8 get from -- I get from our attorney -- it always says, there
9 is -- in other words, that disclaimer is a way out -- is,
10 we'll give you this advice, but there could be other facts
11 that are not considered with the other things that you need
12 to consider. You need to consider other facts.

13 Q. Right.

14 You need to do the work yourself?

15 A. Right.

16 Q. And in fact, didn't Mr. Nagy's memo have those same
17 disclaimers on it?

18 A. All of them have the same ones in my industry.

19 Q. Is that a yes?

20 A. Yes.

21 Q. Now, did your clients have other reasons for doing the
22 stock loan transaction besides tax?

23 A. Yes.

24 Q. Such as diversification reasons?

25 A. Yes.

1 Q. Such as, maybe if they wanted to buy insurance for estate
2 claiming reasons?

3 A. Not particularly in our client's case, but not --

4 Q. I'm sorry.

5 A. -- diversification is the biggest reason.

6 Q. And in fact, at the end -- if the borrower -- did any of
7 your clients walk away from the loan and surrender the
8 collateral?

9 A. Yes.

10 Q. So they did get 90 percent of the value up front,
11 correct?

12 A. In every case.

13 Q. And that was real cash in the client's pocket?

14 A. In every case.

15 Q. So when they surrender the collateral, they were able to
16 get that 90 percent?

17 A. Yes.

18 Q. And it was also a protection for that ten percent
19 downside risk, right?

20 A. Yes.

21 Q. Now, when they surrendered the collateral, they had to
22 pay tax then, didn't they?

23 A. That's correct.

24 Q. So at the end of the loan term, there was a tax law done?

25 A. Yes. But we actually advised our clients to close it

1 earlier. After we found out what we thought was a scheme, we
2 actually went back to the clients and encouraged them to
3 close them out early.

4 Q. Right.

5 But they still had to pay tax even if they closed it
6 out otherwise?

7 A. That's correct.

8 Q. And you said you were a fiduciary to your client,
9 correct?

10 A. That's correct.

11 Q. Did any of your clients sue you over those?

12 A. They did not.

13 Q. Did they agree not to sue you so you could come here
14 and -- and when you did your due diligence, what was Dr.
15 Cathcart's experience in hedging as you recall?

16 A. I recall there was economics, but that was his -- his
17 forte, yes, was the financial part of it, the stock part of
18 it.

19 Q. Now, did you talk to Mr. Nagy?

20 A. No.

21 Q. And then the Government showed you exhibits, I think 235,
22 and 236. Um, did Mr. Nagy send you those documents?

23 A. No.

24 Q. Did Mr. Nagy send you the promotional materials?

25 A. No.

1 Q. Did Mr. Nagy send you the letter about renewing the loan?

2 A. No.

3 Q. Did Mr. Nagy send you the valuation confirmation report?

4 A. No.

5 Q. Did Mr. Nagy send you the activity report?

6 A. No.

7 Q. And you said when you found out that BVL was a lender,
8 you went and looked at the website?

9 A. I called the number off the bottom of the page.

10 Q. Did you go look at the website?

11 A. Yes.

12 Q. This is Exhibit 40. That should be BVL.

13 Do you recall that being the website?

14 A. I don't recall, but...

15 Q. Did you read the website?

16 A. Yes.

17 Q. Did you read the page about how we work, how they had
18 syndicated pools of European investors' money?

19 A. I don't recall.

20 Q. But you read the website, right?

21 A. I do recall going to the website.

22 Q. Do you recall the section in there about stability in
23 their commitment to the long-term success of their clients?

24 A. No.

25 Q. From the website, did you get the impression that it was

1 a large financial institution?

2 A. It's just hard to tell that. No, I didn't.

3 Q. Besides internally, did you get any other tax advice on
4 the 90% Stock Loan?

5 A. From outside?

6 Q. Yes, sir.

7 A. No.

8 Q. As part of your family office services, do you prepare
9 tax returns for your clients?

10 A. Yes.

11 Q. Did you prepare -- does your company prepare any tax
12 returns of your clients that did the 90% Stock Loans?

13 A. I would have to double-check, but I don't believe so.

14 Q. Did you provide any advice to your clients' tax return
15 preparers that they should treat this as a loan for tax
16 purposes?

17 A. Yes. Initially when we entered the transaction.

18 Q. And you wouldn't have given that advice to your clients'
19 tax return preparers if you didn't believe that was true?

20 A. That's correct.

21 Q. Now, you said that as a qualified advisor Derivium paid
22 you a percent of a referral fee?

23 A. That's correct.

24 Q. And I believe that one of the activity reports you did
25 said that there was a \$1.4 million stock loan?

1 A. Yes, or actually \$1.3 million stock loan.

2 Q. Okay. Did you get paid on the value of the collateral or
3 the loan?

4 A. I believe it's on the value of the collateral -- or the
5 loan, I'm sorry -- yeah, the loan.

6 Q. Okay. So the loan was 1.3 million?

7 A. Correct.

8 Q. So your referral fee would have been about \$13,000?

9 A. Correct.

10 Q. So by being -- by receiving a fee from Derivium and being
11 a qualified advisor, um, did you think you were participating
12 in a scheme?

13 A. No.

14 Q. So the mere fact that you were paid money in your mind
15 didn't mean that you were participating in this scheme?

16 A. No.

17 Q. And because you were paid a fee, do you think that you
18 should be assessed for promoting a tax shelter by the IRS?

19 MR. SEACORD: Objection, Your Honor.

20 THE COURT: Sustained.

21 Q. Has the IRS contacted you about 6700 penalties?

22 MR. SEACORD: Objection.

23 THE COURT: Overruled.

24 THE WITNESS: No.

25 Q. From 2000 to -- when was the first year your client did

1 one of these transactions?

2 A. I believe it was late 2001; it could be early 2002.

3 Q. Are you aware that any of your clients' tax returns, any
4 of your clients that did stock loans, that any of the tax
5 returns were audited?

6 A. I believe most of them were sent notices that the IRS was
7 looking at this transaction.

8 Q. Let me put down the day. Prior to 2004, because those --
9 that's when all -- prior to 2004, was one of your tax loans
10 audited?

11 A. I don't know.

12 MR. SEACORD: I'm going to object to relevance
13 grounds.

14 THE COURT: Go ahead. He said he didn't know.

15 Q. Did anyone from Derivium tell you that the IRS had issued
16 a no-change letter?

17 A. I don't recall.

18 Q. And again, while we were talking about disclaimers, this
19 is Exhibit 54, which is a page off the Derivium website.

20 Did you -- did you review the Derivium website?

21 A. Yes.

22 Q. And did you see the on providing tax advice?

23 A. I don't recall that.

24 Q. It was important to you to do your own research as to
25 whether it was a loan or a sale on relying on something that

1 Derivium provided?

2 A. If the stock wasn't sold, it was easy to be a loan. If
3 the stock was sold, it can't be a loan.

4 Q. Did you know Mr. Nagy told the IRS the stock was sold?

5 MR. SEACORD: Objection, Your Honor.

6 THE COURT: Sustained.

7 Q. From the document, did the transaction to you look like a
8 loan?

9 A. Yes.

10 Q. The stock was the collateral?

11 A. Yes.

12 Q. It was a maturity date?

13 A. Yes.

14 Q. There was an interest rate?

15 A. Yes.

16 Q. The amount of the loan was less than the collateral?

17 A. At the inception, yes.

18 Q. And the loan document created an obligation for Derivium
19 to return the stock at the end of the loan if your client
20 wanted it?

21 A. If they chose, yeah.

22 Q. Do those terms comport with your general understanding of
23 what a loan should look like?

24 A. Yes.

25 MR. COOPER: One second.

1 THE COURT: Sure.

2 (Pause in proceedings.)

3 Q. And again, when you talked to Derivium, you inquired
4 about the hedging transaction?

5 A. When --

6 Q. When you were doing your due diligence?

7 A. Yes.

8 Q. And did you speak to Dr. Cathcart about the hedging?

9 A. Yes.

10 Q. Mr. Nagy never told you anything about the hedging, did
11 he?

12 A. I never spoke to Mr. Nagy.

13 Q. And in Exhibit 38, which is the promotional materials, do
14 you recall this article about Dr. Cathcart referring to his
15 hedging strategy as a Coca-Cola syrup?

16 A. Not specifically.

17 Q. You said other banks do this transaction, right?

18 A. Correct.

19 Q. And sometimes maybe it's called a prepaid variable
20 forwards maybe?

21 A. That's correct.

22 Q. And the major banks do it, like Deutsche Bank does it,
23 right?

24 A. Correct.

25 Q. Merrill Lynch does it?

1 A. Correct.

2 Q. Citibank does it?

3 A. Yes.

4 Q. They all do it, don't they?

5 MR. SEACORD: I'm going to object at this point.

6 It's a trans -- he said a pre --

7 THE COURT: Follow up on redirect.

8 MR. COOPER: I forgot which bank.

9 THE COURT: Citibank.

10 Q. But generally I'm asking, even today, banks do stock loan
11 transactions, don't they?

12 A. Not similar to this.

13 Q. Can you explain that?

14 A. Not similar to the Derivium transaction.

15 Q. But they do stock loan transactions?

16 A. True.

17 Q. Yes?

18 A. Yes.

19 MR. COOPER: Thank you.

20 REDIRECT EXAMINATION

21 BY MR. SEADOR:

22 Q. I just have a couple more questions for you, Mr. Polk.

23 Mr. Cooper put a number of documents up there. A
24 lot of them had disclaimers in them; some of them didn't.

25 Did any of those documents that you received from

1 Derivium tell you that the stock was being sold on receipt?

2 A. No.

3 Q. And let's stay on the disclaimers for a moment.

4 There were a number of them that were flashed up on
5 the screen. And you said sometimes you use them in your
6 practice, too. But just because you use a disclaimer, does
7 that mean you can tell your client anything?

8 MR. COOPER: Objection. Calls for legal conclusion.

9 THE COURT: Overruled.

10 THE WITNESS: No, I believe if you go on our
11 website, you've got disclaimers.

12 Q. Doesn't mean you can make stuff up?

13 A. Right.

14 Q. And you said in response to Mr. Cooper's questions that
15 you never talked to Mr. Nagy.

16 Is that your testimony?

17 A. No.

18 Q. Do you know whether or not someone from your office
19 talked to him?

20 A. I believe, but I'm not sure, my partner talked to him.

21 Q. Who is your partner?

22 A. William Nacroisi.

23 MR. COOPER: Objection. 801.

24 THE COURT: Overruled.

25 Q. Would that have been a part of the due diligence process?

1 A. Yes.

2 Q. Mr. Cooper asked you about the referral fee that you
3 received and showed you the activity confirmation for the 1.3
4 million, and mentioned that that would be in the \$13,000
5 referral fee.

6 Can you tell us again what that \$13,000 --

7 A. That \$13,000 was given back to the client.

8 Q. You didn't put it in your pocket?

9 A. No.

10 Q. In all the marketing materials that you received in the
11 due diligence that you did, if you had found out that
12 Derivium was selling the stock upon receipt, would you advise
13 your clients to enter into the transaction?

14 A. No.

15 Q. Why not?

16 A. Because there would be no way to hedge, to protect it.

17 Q. Now, Mr. Cooper asked you about your own research and due
18 diligence that you did before you recommended this to your
19 clients.

20 Did you have access to Derivium's books and records
21 when you did that research?

22 A. No.

23 Q. And Mr. Cooper ran through a litany of banks that he
24 claims do prepaid variable forwards.

25 You expressed familiarity with those?

1 A. Yes.

2 Q. And in those transactions, is the stock sold immediately
3 upon receipt?

4 A. No.

5 MR. SEACORD: I have no further questions.

6 MR. COOPER: Nothing further, Your Honor.

7 THE COURT: Okay. Thank you, sir, you are excused.

8 All right. Why don't we -- did everybody bring an
9 umbrella? Look out the window.

10 We'll break for lunch at this time and we'll start
11 again at 2:00, all right? So we may have some umbrellas
12 downstairs. If you need one, call up, I have some in my
13 office, and I'll loan them to you, all right?

14 So just have the CSO call up there and I'll give
15 them to you if you want them.

16 So we'll see you at 2:00.

17 (Thereupon, the jury retired from the courtroom.)

18 THE COURT: Okay. I think we have corrected it, but
19 don't show those things on the monitor until they are
20 confirmed in evidence.

21 MR. CLUKEY: We have the deposition order.

22 THE COURT: Okay. Thank you.

23 All right. Anything else before we quit? I'll see
24 you at 2:00.

25 (Thereupon, there was a lunch recess.)

1 THE COURT: Anything before we bring the jury back
2 in? Y'all said there was no objection to Bowen's, and one of
3 the other English depositions.

4 MS. WEIS: That's correct. Nothing was ever
5 provided to us.

6 THE COURT: I've got something that they gave me.

7 MS. WEIS: My understanding is we never received
8 anything from Mr. Cooper containing any objections.

9 MR. COOPER: I believe we provided them.

10 THE COURT: Okay. Well, they are right here.

11 MS. WEIS: Your Honor, it's a little more
12 complicated. And is it Bowen or Boyd?

13 THE COURT: I've got objections from Bowen and Wood
14 that Mr. Cooper gave me last Friday. And I don't know
15 whether they --

16 MR. CLUKEY: We were never provided with those
17 objections. And how long ago were they due?

18 MS. WEIS: A couple of weeks ago.

19 MR. CLUKEY: And so the reason why I'm raising it is
20 because --

21 THE COURT: That's the reason I'm raising it, too.

22 MR. CLUKEY: -- it's a video deposition that was cut
23 to be played today because we were never provided with any
24 objections.

25 MR. COOPER: I suppose out of memory -- I don't

1 know -- I mean, the standard is we send everything to
2 everyone, so...

3 THE COURT: Well, I mean, this -- this is dated
4 June 18th.

5 MR. COOPER: That document, yeah. We just tried to
6 provide it in a different format.

7 THE COURT: You know, nothing I can do about it. I
8 just -- I'm reacting to it. They said no objections and
9 then --

10 MR. COOPER: I believe that there was just a few
11 objections, aren't there?

12 THE COURT: Not very many good ones.

13 MR. COOPER: Well, I mean also, Your Honor -- I
14 mean, in the opening statement, they said this fellow never
15 even talked to Mr. Nagy. So with Mr. Debevc out of it, is it
16 even relevant anymore?

17 MR. CLUKEY: During the opening statement, Your
18 Honor, government counsel also explained that Mr. Nagy was
19 paid by Bancroft Ventures after Bancroft Ventures -- well, he
20 was paid until the very end.

21 THE COURT: All right. It looks like, going over
22 these, that the -- all of the objections, at least from
23 Mr. Wood's deposition, are based on 402. There is a
24 relevance objection, which I looked at after the opening
25 statements, I think I overruled all of them, I let it all in.

1 There is no harm no foul, as far as Mr. Wood goes.

2 Now I did sustain Mr. Bowen.

3 Who is first, Wood or Bowen?

4 MR. CLUKEY: We were going to play Wood first.

5 THE COURT: Why don't you take a look. I sustain
6 the objections and we're not going to get to it until
7 tomorrow.

8 MR. CLUKEY: For Bowen, the videotape was destroyed,
9 so we were going to read them anyway, but Wood is ready to
10 go.

11 THE COURT: Okay. So once you take this to your
12 videographer, and you can have all of these -- since I did it
13 on here, I guess after court y'all can go over these and look
14 at my rulings and see if you want to argue any of them. I
15 made the rulings on her.

16 MR. COOPER: Just from procedural, do they read
17 theirs in and we take the book from them?

18 THE COURT: I would read it straight through. It
19 wouldn't make any sense to do it that way, okay?

20 All right. Anything else before we bring the jury
21 in?

22 MR. CLUKEY: No, Your Honor.

23 THE COURT: Do you have any objection, when y'all do
24 the responsive reading, that the court reporter not take down
25 what you are reading since it's all been taken down once?

1 MR. CLUKEY: That's fine.

2 THE COURT: Okay. Any problem with that, Mr.

3 Cooper?

4 MR. COOPER: Okay.

5 (Thereupon, the jury returned to the courtroom.)

6 THE COURT: Okay. Well, I hope y'all survived the
7 flood. So we are going to start now.

8 All right. Do you want to call your next witness,
9 please?

10 MR. SEACORD: The next witness, the United States
11 calls Mr. Roy Strickland.

12 THE CLERK: Place your left hand on the Bible and
13 raise your right hand.

14 State your name for the record.

15 THE WITNESS: Leroy Eugene Strickland, II.

16 THEREUPON:

17 MR. LEROY EUGENE STRICKLAND, II

18 Called in these proceedings and having been first duly sworn
19 testifies as follows:

20 THE CLERK: Be seated around on the witness stand.

21 DIRECT EXAMINATION

22 BY MR. SEACORD:

23 Q. Good afternoon, Mr. Strickland.

24 A. Good afternoon.

25 Q. Can you please tell us your full name and occupation.

1 A. Leroy Eugene Strickland, II. I'm a CPA.

2 Q. And have you come here today prepared to state your
3 expert opinion about the source and use of funds by Derivium
4 from the 90% Stock Loan scheme?

5 A. Yes, I am.

6 Q. Where are you from?

7 A. I grew up in North Charleston. I was raised in
8 Charleston. I presently live in Summerville, South Carolina.

9 Q. Can you describe for the jury your educational
10 background?

11 A. I graduated from Stahl High School in 1981, then went to
12 the Citadel. Graduated from the Citadel in 1985.

13 After that, went to work as a CPA. Since that time,
14 I've had at least 40 hours of continuing professional
15 education each year. I think I've had over a thousand hours
16 since 1985. So a long time.

17 Q. You mentioned you are a CPA.

18 Do you hold any other professional certifications?

19 A. Yes. I'm, as I stated, a certified public accountant.
20 I'm also certified in financial forensics by the American
21 Institute of Public Accountants. I'm a Certified Fraud
22 Examiner and I am a Certified -- I'm a Certified Financial
23 Forensics Analyst.

24 Q. You mentioned you were a certified fraud examiner. Can
25 you tell us what that is?

1 A. That is basically, it's -- the certification is through
2 the Association of Certified Fraud Examiners. It's an
3 international organization. And it's basically, you work in
4 the area of prevention, detection and deterrence of fraud.

5 Q. Can you please describe your professional employment to
6 date as it relates to why you believe you are qualified as an
7 expert in this case?

8 MR. COOPER: Your Honor, we'll stipulate that he can
9 be tendered as an expert, if you want to speed things along.

10 MR. SEACORD: I would like the jury to get the
11 background.

12 THE COURT: Give the *Readers Digest* version.

13 THE WITNESS: After graduating from the Citadel, I
14 went to work with Arthur Andersen in Columbia, South
15 Carolina, went to work there until 1991.

16 Moved back to Charleston and started the CPA
17 practice with Barry, Patricia Wilson and Pratt Thomas.

18 And then in 2007, we merged in with a larger
19 regional firm called Dixon Hughes, where I have practiced
20 from '85 until the last probably two years.

21 My primary practice area was auditing. I worked in
22 the audit practice. And then in addition, I've worked in the
23 forensic area of our practice since the early '90s. And
24 presently, I am the partner in charge of the forensic
25 evaluation practice for Dixon Hughes, the entire firm.

1 And then naturally, I work in that practice area in
2 the Charleston office.

3 MR. SEACORD: The United States tenders
4 Mr. Strickland in the field of accounting and as a Certified
5 Fraud Examiner. He's qualified by the training, experience
6 and education providing opinions on the source of funds of
7 Derivium.

8 THE COURT: No objection. Go ahead.

9 MR. SEACORD: I would also like to move at this time
10 in evidence a copy of Mr. Strickland's CV.

11 MR. COOPER: No objection.

12 MR. SEACORD: That will be 351.

13 THE COURT: Okay. Thank you.

14 (Thereupon, Government's Exhibit Number 351 was
15 received in evidence.)

16 Q. Mr. Strickland, what were you asked to do in this case?

17 A. Basically, I was asked to get an understanding of the
18 cash flows related to Derivium and the Derivium-related
19 entities on the cash coming in, the cash going out. And then
20 specifically, to try to get an understanding of the 90% Stock
21 Loan transaction Program, how that actually operated.

22 Q. And did you form any opinions in connection with this
23 assignment?

24 A. Yes. Basically, that is summarized into four or five
25 opinions.

1 Q. From an accounting standpoint, did you form an opinion
2 regarding the hedges that were supposedly in place?

3 A. Yes. In looking at these transactions from when we
4 started in early '98 through 2005, I saw no evidence of
5 hedges being placed on any of these investments.

6 Q. And from an accounting standpoint, did you form an
7 opinion about the collateral, the stock that was given by the
8 customer to Derivium?

9 A. Based on the work that we did, all the bank statements,
10 brokerage statements looking at detailed records from the
11 beginning to the end, the stock, when it was transferred to
12 Derivium, it was sold, in most cases immediately, at least
13 within a couple of days.

14 Q. And from an accounting standpoint, did you form an
15 opinion about the quarterly statements that were sent by
16 customers, sent to customers by Derivium?

17 A. Yes.

18 As they've already -- the exhibits show that on a
19 quarterly basis there was a statement that was issued showing
20 the activity in the account. And at the bottom it had a
21 listing of collateral that -- and that was -- that statement
22 was provided throughout the loan. That collateral did not
23 exist. It was sold on day one. The stock did not exist.

24 Q. From an accounting standpoint, did you form an opinion
25 about the condition of Derivium's books and records?

1 A. When we looked at the books and records for Derivium,
2 their QuickBooks' records, their general ledgers were based
3 on two areas -- there were a lot of areas, but two primary
4 areas: The stock that was transferred from the clients to
5 Derivium was never recorded on Derivium's books. \$1 billion
6 worth of transactions, close to that, where individual
7 stocks, Microsoft, IBM, etcetera, were transferred into
8 accounts in Derivium's name and subsequently sold, though
9 that transaction was not reflected on the books and records.

10 And then the second primary area is with the ten
11 percent money, they started -- Derivium started making
12 transfers to third -- to startup entities, is what you would
13 call them, little companies in Summerville and Orangeburg.
14 They were paying expenses directly for those companies, and
15 they were actually transferring some funds to those
16 companies.

17 That -- and that was happening frequently, you know,
18 like in accounting, everything is kind of day-to-day. Those
19 entries, in most cases, were booked in bulk. Sometimes they
20 were only booked until the end of the month or the end of the
21 year. There was no detail from the evidence that I looked
22 at, no supporting documentation other than a transfer.

23 Q. You just testified that one of your opinions was related
24 to the hedges.

25 Can you explain from an accounting perspective what

1 a hedge is?

2 A. Basically, hedging is a bet, from a simple standpoint.
3 It's something you purchased to address a risk in the future,
4 stock going up; stock going down. And there are a variety of
5 hedges, but that's basically a look at it. Think of hedging
6 your bets.

7 Q. And in this situation, risk against what? What are you
8 trying to determine?

9 A. The risk -- you are trying to protect -- I mean, the risk
10 is to the customer, the client. And giving the stock to
11 Derivium, there was the potential that in the future if it
12 goes up in value, they will participate in that. That risk
13 was not addressed. There was no hedging product purchased
14 that I could identify on their accounting records for that
15 risk.

16 Q. You also use the word "collateral," and talking about one
17 view. From an accounting perspective, tell us what
18 collateral is?

19 A. I'll just tell you, from an accounting perspective,
20 anybody's perspective, collateral is basically something of
21 value that you pledge in order to receive something in
22 return.

23 Some -- and a simple example is you want to get --
24 you've got a car or a house, you want to get a loan on that.
25 Well, you actually pledge that to the bank in order to

1 secure, if you don't pay your loan in the future, that
2 they'll have that property. That's what collateral is.

3 Q. Now, in order to form the opinions you just told the jury
4 about, can you tell us what work you performed?

5 A. Yes. We -- we started out with basically trying to get
6 our arms around it. We are dealing with a pretty long period
7 of time from, I think it was March of 1998 to -- it was July
8 of 2005. So we wanted to identify the companies, the period
9 of time, the -- and then we went and found the bank
10 statements and brokerage statements. And we put all that
11 information into -- we used QuickBooks, also. It's just a
12 way to get paper into the computer system to where you can
13 work with it.

14 Once we got the information in, everything tied into
15 the banking records, we had all the detailed activity. And
16 then we went -- we had, I think it was 600,000 pages of
17 documents, and it's 190,000 files that we went through, to
18 try to classify the transactions. Those documents included
19 loan agreements, the quarterly statements that we've already
20 mentioned, might be wire transfer documents, could be e-mails
21 and things of that nature. So we took all that information
22 and went back into the QuickBooks and tried to classify the
23 transactions.

24 We also read, there is various depositions,
25 testimony, etcetera that was taken in this case to help us

1 add up some of the details of actually what was happening.

2 And then lastly, we compared our work to a
3 QuickBooks report for Derivium, and we didn't -- we didn't
4 try to reconcile it to the penny. As a matter of fact, there
5 is some pretty big differences, but we wanted to get a true
6 understanding overall if it tied in.

7 And then lastly, we did enough work to make sure
8 that -- that we understood how the cash flow was working and
9 how these loans were working, and reconciled from that
10 standpoint.

11 Q. You mentioned -- you looked at a number of bank
12 statements.

13 Can you tell us approximately how many bank accounts
14 you were looking at?

15 A. We were dealing with 38 bank accounts. I think we looked
16 at -- the total months was over 1,200 months, and we had in
17 excess of 45,000 transactions that we dealt with.

18 Q. From your review of the records, what is your
19 understanding of how the 90% Stock Loan worked?

20 A. This is one of the things we also did early on is, as I
21 mentioned, going through these documents, um, there was a
22 variety of marketing information that was put out, and some
23 of that I think has already been displayed earlier today.

24 But in a simple form, if somebody held a stock for
25 \$500 and it went up in value to \$1,000, well, if you want --

1 a stock is a piece of paper. You can't spend -- Piggly
2 Wiggly doesn't take stock, you can't spend it. So you want
3 to turn that into cash. Well, if you turn it into cash and
4 sell it, you've got to pay taxes on it.

5 So what this program was marketed is a way to turn
6 that paper into cash without paying taxes. You signed a --
7 you gave -- you pledged your stock and they gave you a note
8 for 90 percent of that money, but it had these benefits.

9 You weren't required to pay the loan back, you could
10 just walk away. But then the other benefit was substantial,
11 that if it actually went up in price in the future, they were
12 going to loan you the money and also give you 90% of that
13 increase.

14 And they were going to do this through, in the
15 literature it's called a proprietary hedging model. That's
16 how they were supposed to do this. We didn't see this. All
17 we saw was the 90% loan and the cash that there was no
18 hedging.

19 Q. You sort of anticipated my next question, but based on
20 your review of the books and records of Derivium, what did
21 you determine actually happened?

22 A. This is what happened. You pledged your stock. Derivium
23 gave you 90% of it back; they kept ten percent for their own
24 benefit and they let it ride. There was no hedging activity
25 that I could identify. You just hope that the stock went

1 down in value.

2 Q. And did you create a chart or a pictorial of that -- what
3 you just described?

4 A. Yes, I did.

5 Q. Okay. If we can pull that up.

6 Who created this chart, Mr. Strickland?

7 A. Well, the actual -- I put all the information in. It was
8 created by my group.

9 Q. Okay. And is this an accurate representation of the
10 transaction, based on your review of the books and records?

11 A. Yes.

12 Q. Okay. And can you tell us in a little bit more detail
13 what's pictured on here?

14 A. Yeah.

15 If you look at it, you start over on the left-hand
16 side, that's the customer, the client. You basically get a
17 piece of paper, it's a stock certificate. Now we know those
18 are in accounts. You don't actually get a piece of paper,
19 but it's a piece of paper.

20 The -- once the stock comes over, that little house
21 there, that's Derivium and the Derivium-related entities, it
22 comes in. They sell it; turns that piece of paper into cash.
23 They give you \$900,000 back tax free. They kept 100,000 for
24 their own benefit. That's how the transaction worked.

25 You don't see the 100,000, you see the 900,000 cash

1 going to the client. You start -- you turn it into a million
2 dollars. The hundred thousand that was left over stayed with
3 Derivium.

4 Q. In your review of the books and records -- and I think
5 you sort of mentioned this already -- but were customers sent
6 any sort of communications indicating what was going on with
7 their stock?

8 A. Yes, they were.

9 Q. And can you talk generally about what sorts of
10 communications they were given?

11 A. Yeah.

12 When you -- we use these documents in pulling this
13 information together. And basically, after you fill out the
14 loan application, we have a valuation report. The valuations
15 report really didn't mean anything, it had a value and it
16 said stock received.

17 Once you transferred the stock in, they sent what
18 was called an activity report. And it says on the report,
19 securities hedged, and it would give the number of security,
20 the number of shares and the value.

21 So you end up at the end with a million dollars.
22 And then they would give you the loan balance, which in the
23 case of a million dollars would be 900,000. That's basically
24 what it showed, but it showed that it was hedged.

25 Well, what was actually happening is it was sold.

1 It sold the stock to get that value to determine how much
2 actually they had to send back to the client. That was the
3 transaction. There was no hedging.

4 MR. SEADOR: Sam, can we pull up Government
5 Exhibit 236, which has already been entered into evidence?

6 Q. Mr. Strickland, do you recognize this document?

7 A. Yes.

8 Q. And is this the activity confirmation you were just
9 describing?

10 A. Yes.

11 As you can see here at the top left-hand corner, it
12 would give the name of the client, client number, loan
13 number. And the comment I was referring to is where it says
14 in the middle, securities hedged to date, securities hedged
15 to date. And then you've got the date, the stock symbol, the
16 number of shares; and it actually says shares hedged, not
17 shares sold, it's shares hedged, and then the hedge value,
18 the shares remaining, and then the total value of \$1,446,000.

19 And then down below, you will see the actual loan
20 amount of 1.3 million. That's what the customer would
21 receive back in return. And the difference between the
22 1,466,000 and the 1,301,000, that's the money that Derivium
23 would retain. And you can also see at the bottom it has the
24 net due to client as a result of the hedging activities to
25 date.

1 Q. Just so I understand, the line in that middle section, it
2 says "actual loan amount at 90% of hedged value 1.3 million".
3 That's what the customer would receive?

4 A. That would be the amount that the client would get back.

5 Q. And I think I understand your testimony, correct me if
6 I'm wrong, the money that they got back was from the actual
7 sale of their stock?

8 A. Just get back to the simple example, it would be like
9 going to get a car loan, taking the title. You got a car
10 that's worth \$2,000 -- let's say \$1,000. Make it simple.

11 You go to the car, title loan place, and you say, I
12 want to pledge my car to get a loan. It would be like them
13 taking the car and selling it and giving you \$900 back.

14 That's what happened here. That car that you -- you
15 couldn't drive your car anymore. That's what was happening.

16 Q. Did you discover any other correspondence in the files
17 that you reviewed that was sent by Derivium to customers
18 about what was going on with collateral?

19 A. The other major report, as I've already talked about, was
20 the quarterly summary they would send the client every
21 quarter. And it would tell you the balance of the loan.
22 Now, this loan accrued interest, so it had the balance of the
23 loan.

24 Then it would also have at the bottom, they would
25 track the securities as if they were still held. It would

1 actually say the number of shares, if they were dividends,
2 and it said collateral.

3 If there were dividends that were paid on the stock
4 each quarter, that would show up in there. If there was a
5 stock split, or if somebody bought the company, that would
6 show up as if those shares existed.

7 It says collateral. And then it actually had the
8 value of the collateral on the quarterly statement.

9 And as I understand it, that was received every
10 quarter showing the activity in the loan. That collateral
11 did not -- the collateral did not exist; it was sold.

12 MR. SEACORD: Your Honor, can I approach the
13 witness?

14 THE COURT: Sure.

15 Q. Mr. Strickland, I handed you what's been marked as
16 Government Exhibit 155 for identification.

17 Can you identify that?

18 A. Yes. This is a quarterly account statement I was just
19 talking about.

20 Q. Is that the type of statement that you reviewed in the
21 files of Derivium?

22 A. Yes.

23 Q. Does that appear to be an accurate copy of that
24 statement?

25 A. Yes.

1 MR. SEACORD: I would like to move Exhibit 155 into
2 evidence.

3 MR. COOPER: 602 objection. 801.

4 MR. SEACORD: First we are not offering it for the
5 truth of the matter asserted.

6 THE COURT: All right. Overruled.

7 Just to explain, when they are spouting out these
8 numbers, that means something to me; that doesn't mean
9 anything to you. They are Federal Rules of Evidence. They
10 are my numbers.

11 What the lawyers do, when they tell me what the
12 number is, I know what the number is, I know what the basis
13 of the objection is, and I can rule on it. You don't have to
14 worry about the numbers. I promise you, you don't want to
15 know all those numbers.

16 So go ahead.

17 (Thereupon, Government Exhibit Number 155 was
18 received in evidence.)

19 Q. Okay. Mr. Strickland -- well, why don't you explain
20 what's on this document.

21 A. Maybe y'all can't see it, but up at the top, left hand
22 is, again, the client address. And then you have on the
23 right-hand corner the loan application -- or excuse me -- the
24 loan information that's at the very top. It all stays the
25 same between these statements.

1 And then in the middle section, this is -- this is
2 showing the loan balance, as you can see, gives the beginning
3 of the quarter balance. As I've explained, the loan did
4 accrue interest, um, then the end of the quarter loan
5 balance.

6 And then if you look down at the bottom, it has end
7 of quarter collateral value. That's the collateral we have
8 been talking about that was sold on day one.

9 On the right-hand side is the account details, and
10 it basically tells you the original loan amount, date of
11 maturity, interest rate, etcetera.

12 And then if you go down to the bottom, on the very
13 bottom section here, this is where I was explaining, they
14 were actually keeping track of the activity as if the shares
15 still existed. It's the symbol, the company's name, the
16 number of shares at the beginning, if there were dividends
17 paid, that would be put in there. Um, stock split, they say
18 there is none.

19 In addition, if somebody purchased a company, you
20 would show -- it would show that stock going to zero, and
21 then the new company stock replacing it to get you an ending
22 number of shares that represents the collateral, which is --
23 that's -- it's gone. It's sold.

24 Q. So if I understand your testimony, this quarterly account
25 statement shows 350,000 shares of Labor Ready, Inc. stock.

1 In this particular quarter, was that stock, based on
2 your review of the books and records, actually there?

3 A. No. I mean, I didn't look specifically on it -- I didn't
4 look specifically at this one.

5 But basically, each time the stock came in, it was
6 sold. There was no stock held -- excuse me --
7 stock/collateral. It was sold immediately.

8 Q. In your view as an accountant, is this document conveying
9 that the collateral actually exists?

10 A. Let me see what it says. Collateral activity details. I
11 think it looks like it exists. I mean, I don't know that I
12 can add anything to that. It says what it says.

13 And I'm going to take that in conjunction. If you
14 go up -- if you could go back up in the middle section, not
15 only do you have the shares activity, but you actually -- it
16 gives you the end of quarter collateral value.

17 Q. That's the value of the supposed stock that's being held?

18 A. Yes.

19 Q. Let's talk about a customer's options at the end of the
20 loan.

21 Based on your review of the books and records, what
22 options did they have at the end of the three-year period, or
23 whatever the loan came due?

24 A. There were basically three options at the end.

25 The first option, and the best option for Derivium,

1 is your stock goes down and you just walk away from the loan.
2 You didn't have to pay anything back; you got your 90%; you
3 are gone.

4 The middle option is, it could happen when the stock
5 is down or the stock went up in value. At the end of the
6 three-year period, you could actually just renew the loan.
7 If the stock -- if you thought it was going to go up in
8 value, maybe it wasn't there yet, you just renew it for three
9 years.

10 If the stock went up in value during that time
11 period, you could actually ask them to pay you the cash
12 difference between this present value and your loan balance,
13 90%. So you could get an additional piece of money, cash,
14 for that appreciation. That was the second option, renew or
15 refinance is what it's called.

16 The third option, and this is the worst case for
17 Derivium, your stock goes up, maybe it doubles, and you've
18 got a million dollars' stock, and it goes up to \$2 million,
19 you actually tell them, I want my stock back. What they
20 would have to do -- you would pay your loan off. They would
21 have to find the cash to go out and buy that stock. It
22 didn't -- it was gone. So they would have to go into the
23 market and buy those shares for you in order to replace your
24 stock.

25 That's the worst scenario for Derivium.

1 Q. What happens, based on your review of the records, when a
2 client elected that third option to get the stock back, let's
3 say appreciated, using your example, to \$2 million, what did
4 Derivium do?

5 A. Derivium would have to -- you've got to realize, Derivium
6 had no capital. When I say "capital," it wasn't like other
7 people put outside money into this deal. They started off in
8 2001 with negative equity. There is no capital.

9 At the end, they had a negative \$5 million in
10 equity, so there is no other money than that ten percent. So
11 you had to hope that there was enough money in the ten
12 percent, you had enough people doing this, to be able to go
13 out in the market and buy this stock.

14 Well, that's the problem with this. They weren't
15 able to meet those obligations and things fell apart.

16 Q. Did you create a graph or pictorial of that, what you
17 just described?

18 A. Yeah. I've got one on the worst case that kind of
19 explains it.

20 Q. Can you describe, Mr. Strickland -- did you create this?

21 A. Yes.

22 Q. Okay. Can you describe what is depicted here?

23 A. This is the worst case scenario for Derivium. The client
24 has the loan, and I used the example a million dollar loan.
25 It's -- three years later there has been interest that's

1 accrued on there. Now the loan has a balance of \$1,200,000.
2 The stock now is worth \$2 million. They don't have the
3 stock.

4 So the client would pay them the loan, pay them
5 \$1.2 million. And you can see again, it's all happening in
6 the same house. It's Derivium-related companies. The client
7 pays the 1.2 in. Derivium's got to find \$800,000 out of that
8 ten percent, they've got to find that.

9 They go to Wall Street, go to the market, buy those
10 specific shares and give them back to the customer. That's
11 what they weren't able to do. There was no protection. They
12 didn't have any protection in place, hedging to address that
13 risk. You just had to let it ride and hope that you had the
14 money.

15 Q. I think you answered this already, Mr. Strickland, but
16 were there cases, based on your review of the books and
17 records, where a client's stock had appreciated, the client
18 wanted that stock back; and as you said, they go and buy it
19 back, but were there cases when Derivium couldn't do that?

20 A. Yes. That's why this thing went down. They couldn't do
21 it. There was no hedging in place. They only had ten
22 percent to work with.

23 Q. Now, you've testified that you have examined Derivium's
24 books and records.

25 A. Yes.

1 Q. And did you identify any issues with those books and
2 records?

3 A. Yeah. The -- the first thing we noticed right away is,
4 realizing we've got a billion dollars worth of transactions
5 here, but it's made up of a lot of loans, a lot of
6 individuals with stock, their books and records did not show,
7 anywhere that we can find, the receipt of that stock. When
8 the customer transferred the stock into a brokerage account
9 in their name, in Derivium's name, the books and records
10 didn't reflect it, nor did the books and records reflect that
11 detailed sale. It just didn't show it, that major piece.

12 \$1 billion worth of individual transactions coming
13 into this business, individual stocks coming into a Derivium
14 brokerage account, were not recorded on the books and
15 records.

16 Q. As an accountant, would you expect to see those recorded
17 on the books and records?

18 A. Yes.

19 Q. Why is that?

20 A. They are received in your account -- it would be similar
21 to a bank. When we deposit money into the bank, they record
22 the cash and they record a liability on their books for that.

23 Well, in this case, it wasn't cash, it was stock
24 that was received into their brokerage account. They didn't
25 record that at all.

1 Q. In your review of the books and records and all the
2 various banks and bank accounts that you described, where
3 were they located geographically?

4 A. The --

5 Q. The bank accounts.

6 A. The bank accounts were --

7 Q. The U.S. accounts.

8 A. Yeah. You will hear about all these different entities,
9 um, the bank accounts were U.S. accounts, they were, the --
10 bank accounts were all coming to Derivium. Everything was
11 coming into Derivium that I can -- that I could find.

12 Q. Did you see any evidence of lenders?

13 A. You see documents about lenders, um, letters and things
14 like that at the very beginning. All these transactions
15 occurred on Derivium's books.

16 Later on, they developed some offshore lender, but
17 the transactions still continued. They set up a new bank
18 account, but all the transactions were directed, all the
19 activity, was directed by Derivium employees.

20 And they actually -- there was supposedly some
21 financial declarations that the offshore lenders had to
22 report. Derivium had to provide that information, too.

23 So all of this happened within Derivium, all of the
24 cash, all the activity, it happened within Derivium.

25 Q. Now, you said it twice "their activity". What do you

1 mean "activity sale" and --

2 A. Yeah. This is all we do all day, stocks coming in, cash,
3 selling it and getting cash in return, and then giving the
4 client back 90% of their money and keeping ten percent of the
5 money.

6 Ten percent of the money was used for their
7 operating expenses, payroll, etcetera, and then we'll talk
8 about this a little later, they also started making
9 investments in these startup companies in Summerville and
10 Orangeburg.

11 Q. That was my next question for you, Mr. Strickland.

12 Besides the fact that the receipt and sale of stock
13 wasn't reflected on the books and records of Derivium, did
14 you see any other issues with the books and records?

15 A. Yeah. The -- they had -- and I'm talking in the tune of
16 \$30, \$40 million worth of transactions with these startup
17 companies, and these -- basically, you had transfers, and the
18 transfers were going directly from Derivium, in most cases to
19 these companies.

20 And in some cases, these companies actually, like
21 their payroll, or they've got a bill from their vendor,
22 Derivium paid it directly. Those were booked in bulk
23 entries. Sometimes they booked it at the end of the month;
24 sometimes they trued it up at the end of the year.

25 But the key here is, as I understand it, they are

1 saying that these are -- that's not unusual -- but there was
2 supposedly an unrelated third-party entity involved with
3 this -- and they will get into this later on.

4 If there was a third party, like the bank being a
5 separate offshore company, there was a third party, you have
6 detailed records. Those -- you wouldn't just willy-nilly
7 send \$100,000 based on an e-mail. You would have detailed
8 records on each one of those transactions. And those records
9 did not -- those records and the transactions were not
10 recorded; they were only recorded in bulk at the end of the
11 month.

12 Q. Let me ask you a couple of followups.

13 You mentioned a couple times startup companies.
14 What is a startup company?

15 A. A startup company is basically a company that is starting
16 from scratch. They typically either have very little
17 revenues, because they are just starting up, maybe brand
18 new -- it's basically taking a business with no sales and
19 getting it off its feet.

20 A lot of times it's in a new technology, a new
21 product. A lot of these are in the building industry, that
22 they were basically startups and from scratch.

23 Q. And you mentioned there were multiple transfers to those
24 companies without any substantiation.

25 Would you expect to see substantiation for

1 transfers?

2 A. Yes. You would have day-to-day -- these transactions
3 would be recorded day-to-day. As the money was coming -- you
4 wouldn't send somebody \$100,000 and not record it on your
5 books and records; wait until the end of the month if it was
6 truly a third-party transaction.

7 Q. And how did Derivium, based on your review of the
8 records, how did they describe or explain what was going on
9 here with these transfers from Derivium to the startups?

10 A. They explained that these weren't -- that -- they are
11 explaining, on one hand, that you want to explain -- they
12 want to explain that this is a true third-party entity.
13 These are true hedges or investments that they are making.
14 And that -- and there is an entity that you will hear about
15 that they say is in there.

16 If you use that argument, then every transaction is
17 detailed. Now, most of these entities were owned, they were
18 owned by Debevc and Cathcart. So you set this company up,
19 you take your money out of Derivium, and you are transferring
20 it over to these entities owned by Debevc and Cathcart. I
21 don't see how that addresses the risk of these customers. I
22 mean, that is what was happening.

23 Q. Did you create a, sort of a chart to explain this?

24 A. Yeah. We probably should have gotten to that before.

25 Q. So let's take a look at this.

1 And why don't you explain to the jury what's
2 depicted here?

3 A. This is the \$100,000 we are talking about. A million
4 dollar transaction. Client gets 900. They keep 100. They
5 had to pay their cost of operations, things of that nature,
6 that's down at the bottom, but they are saying that they then
7 put \$100,000 into a company called Spencer Partners, which is
8 supposedly this offshore company, then to Shenandoah, which
9 is -- Shenandoah is an entity owned by the Cathcarts and
10 Debevc. And then it went to all these other little
11 companies.

12 What they would do, the money would go directly from
13 Derivium to these entities. And then at the end of the
14 month, they would make journal entries, just record to make
15 it look like it went through those companies. It didn't.

16 And if it really was going through those companies
17 and Spencer Partners was a true third-party, unrelated
18 third-party "offshore company," these transactions would have
19 happened on a day-to-day basis.

20 Spencer Partners would be taking a 40-plus million
21 dollar liability for these amounts, and I don't think they
22 would take that lightly.

23 So this is why we went -- they went back and made
24 the books look like this, but this is what was actually
25 happening. There is another chart.

1 Q. I probably should remind the jury that these are just
2 demonstratives to sort of illustrate for what Mr. Strickland
3 did. It's not evidence.

4 A. The money was going from Derivium entities directly to
5 these startup entities. Sometimes it didn't even go to the
6 startup entity; it went directly to their vendor. The vendor
7 sent a bill and Derivium just paid it.

8 And then they would go and make the journal entries
9 to make it look like this is what was actually happening, and
10 then they would go and make it look like -- if you will go
11 back to the previous chart -- they make the books look like
12 this.

13 Q. So if I understand you correctly, the money was really
14 going right to the startups, but at some later time, they
15 would go back and change the books so it really looked like
16 it was flowing like this?

17 A. In the majority of the cases, it was direct.

18 MR. SEACORD: Thank you, Mr. Strickland. I don't
19 have any other questions.

20 CROSS-EXAMINATION

21 BY MR. COOPER:

22 Q. I just want to hand you a copy of the report.

23 A. Yes, sir.

24 Q. Mr. Strickland, during your testimony, you didn't -- I
25 don't believe you even said Mr. Nagy's name, did you?

1 A. No, sir.

2 Q. And when we were looking at those demonstratives and we
3 were talking about Derivium, that was a Cathcart/Debevc
4 controlled entity?

5 A. Which entity?

6 Q. Derivium?

7 A. Derivium? It was controlled by Mr. Cathcart and Mr.
8 Debevc. Mr. Nagy was involved, as I understand it from the
9 information that I've read, from the very beginning of these
10 organizations, in the structure, the tax structure of these
11 transactions; in the preparation of the tax returns for these
12 entities; in the -- assisting with the books and records at
13 the end of the month, or the end of the quarter, or the end
14 of the year; with pulling these reports together that
15 supposedly were going to these third-party entities; with
16 reviewing and commenting on the marketing materials. And I
17 didn't mention that previously, he was involved with it from
18 the beginning to the end from an accounting standpoint and a
19 tax advice standpoint, yes, sir.

20 Q. Thank you for that.

21 Was Derivium a Cathcart- and Debevc-controlled
22 entity?

23 A. It was owned by Mr. Cathcart and Mr. Debevc, yes.

24 Q. Did Mr. Nagy own any of Derivium?

25 A. I don't believe he owned any of Derivium.

1 Q. Was he an employee of Derivium?

2 A. No, he was not.

3 Q. Did Derivium have its internal -- have an internal
4 Certified Public Accountant?

5 A. Did he have an accountant? I think he was a CPA, yes.

6 Q. And his name is Mr. Robert Brandenburg. Is that your
7 recollection?

8 A. Robert or Mark, yes, it's Brandenburg.

9 Q. And then in addition to Mr. Brandenburg, Derivium also
10 had other bookkeepers?

11 A. Yes, they had other bookkeepers.

12 Q. Debbie Young. Is that one of them?

13 A. I don't know all the names by heart, but they had a
14 bookkeeping staff.

15 Q. What about Ms. Hawk?

16 A. I've heard that name.

17 Q. What about Catherine Sandifer?

18 A. I don't know all the specific names. I apologize.

19 Q. And Mr. Nagy was a solo practitioner that was the outside
20 accountant for Derivium, right?

21 A. Mr. Nagy was, as I understand, the outside accountant for
22 Derivium --

23 Q. And in your report --

24 A. -- and for Derivium and all the -- that I know of, all of
25 the related entities.

1 Q. And in your report, you didn't mention Mr. Nagy's name
2 once; is that right?

3 A. No, I did not.

4 Q. So you are not giving an opinion as to what books and
5 records Mr. Nagy looked at?

6 A. In the -- I don't know the specific books and records,
7 but I've read, you know, hundreds of pages of depositions
8 related to his involvement, so...

9 Q. And as an outside accountant, isn't the information you
10 have access to what your client gives to you?

11 A. Yes.

12 Q. Like yourself, you are a CPA at Dixon Hughes, so you only
13 have access to what your client gives you, right?

14 A. Yes, sir.

15 Q. Did you review any of the accounting information in Mr.
16 Nagy's files?

17 A. I think we might have been provided that at the end, if
18 there was some -- we -- we were provided information by the
19 various law firms. We didn't get to talk with the various
20 professionals. A lot of them were being sued individually at
21 the time and we didn't go through that effort, but I do
22 believe we had somebody talk with Mr. Nagy regarding the
23 books and records, though.

24 Q. And I -- and that brings up a good point. In Exhibit
25 Appendix C to your report, the information you relied on,

1 that there is not a single deposition testimony listed there;
2 is that correct?

3 A. I don't know that there is.

4 Q. So you didn't read Mr. Nagy's specific testimony in
5 forming your opinion?

6 A. Yeah, I read Mr. -- we read Mr. Nagy's -- he had some
7 depositions outstanding. I believe we had them prior to the
8 issuance of the report.

9 Q. Well, this report was issued in June of '09.

10 A. No, I think there was -- I might be mistaken on this, but
11 I thought he had some depositions in the prior matter. I've
12 read a variety of depositions.

13 Q. But you didn't list them in that report, did you?

14 A. No, I didn't.

15 Q. And then what's your billable rate?

16 A. My rate is -- my rate is \$325 an hour.

17 Q. How much have you billed on this matter?

18 A. The Government is in the \$60,000 range.

19 And to explain that, I haven't done all this work
20 myself. We have staff that work on this with me. Our
21 average rate staff is as low as \$100 an hour. Our average
22 rate is \$165 to \$175 an hour for everybody working on the
23 engagement.

24 Q. You also mentioned your report was used on another
25 matter?

1 A. There was another suit.

2 Q. Hold on. How much did you bill in that matter?

3 A. It was -- I don't know the exact number -- it was over
4 \$200,000.

5 Q. So a total of \$260,000?

6 A. That's in the ballpark. We --

7 Q. There is no --

8 MR. COOPER: Your Honor, there is no question
9 pending.

10 THE COURT: Go ahead.

11 THE WITNESS: Can I explain, sir?

12 That represents 27 or 2800 hours of work, um, 26
13 people working on this engagement since March of 2006.

14 We -- we first got involved with this engagement in
15 March of 2006, so that dollar amount is over a long period of
16 time and a lot of work.

17 Q. Now, you talked about the company's books and records.
18 And you said that there was no indication of stock being sold
19 in the books and records.

20 Is that correct?

21 A. That's correct.

22 Q. But Derivium did have in its possession the brokerage
23 account statements, correct?

24 A. They had the brokerage account statements.

25 Q. And like you said, in 2001 the brokerage account

1 statements were actually in the name of Bancroft Ventures
2 Ltd., the lender, right?

3 A. In prior -- there was a period of time, and I don't know
4 the exact dates, Mr. Cooper, but for a while, this was all
5 done within Derivium. And then the attorneys and everybody
6 met and they put in this new layer, which is these offshore
7 companies. The documents, the brokerage statements,
8 etcetera, they all continued to come to Derivium.

9 And as I can tell, all the transactions were
10 directed by Derivium, loan applications, everything. Nothing
11 really changed other than the name on the brokerage
12 statement, but it was called Bancroft, and sometime in '01,
13 and I think it stayed that way to -- maybe until the end.

14 Q. Are those brokerage account statements books and records?

15 A. That would be support. That would be support for the
16 books and records.

17 There -- the reason we go to the brokerage
18 statements is that's third-party information, just like we
19 all have bank accounts, it's coming from the bank. So we
20 start with that.

21 And then what you will see is that information would
22 be recorded in your financial statements, you know, all your
23 checks are recorded in the books and records, all your stock
24 transactions, etcetera, would be recorded in the books and
25 records.

1 So to answer the question, it probably would be more
2 accurate, more reasonable to call that support for the books
3 and records.

4 Q. But the brokers' statements weren't for Derivium stocks?

5 A. Yes, we had brokers' statements.

6 Q. And you also indicated these, the value confirmation
7 reports.

8 Is your understanding these reports are maintained
9 from a database maintained by Derivium?

10 A. I don't know exactly where they actually -- I think they
11 came from various files and records.

12 Q. Well, physically how they were generated, do you have an
13 understanding of whether or not that when the stock came into
14 the brokerage account, that information was put into a
15 database by Mr. Kelley?

16 A. Yes, it was.

17 Q. And when the information was put into the database,
18 didn't it spit out this report?

19 A. Yes, sir.

20 Q. And as well, when you turn the page, the activity
21 confirmation report, correct?

22 A. Yes, sir.

23 Q. And my understanding is when the stock was sold, again,
24 Mr. Kelley inputted into the database the date of the sale
25 and what was sold.

1 Is that your understanding?

2 A. Yes, sir.

3 Q. And when he put that into that database, did it -- it
4 spit that report out.

5 Is that your understanding?

6 A. Yes, sir, that's how it happened.

7 Q. So they were putting in the receipt of the stock into the
8 database and they were putting in the sale of the stock into
9 the database, right?

10 A. They were putting it into the database. They were not
11 recording the transaction in their financial statements.

12 Q. Oh, so those are different books, but it was in that
13 database's books and records?

14 A. It would be like, um, somebody recording sales. You've
15 got all these invoices and you are keeping track of them over
16 here, but you don't put it in your financial statements.
17 It's the same example.

18 So they were keeping track of it on, as I understand
19 it, in these off the books, in these off the book databases,
20 but they were not recording that. They weren't recording it
21 in the financial statements.

22 Q. And you said you use QuickBooks?

23 A. Yes, we do.

24 Q. Is that what Derivium used, too?

25 A. That's the accounting software that they used.

1 And it goes to show -- I mean, QuickBooks can -- we
2 actually put all the transactions in QuickBooks. You can
3 record the stock, so...

4 Q. So you can record the sale of the stock in QuickBooks,
5 right?

6 A. There is two points here. Let me make this clear. They
7 did not record the receipt of the stock on their financial
8 statements, nor the sale of that stock, and you can do that
9 in QuickBooks.

10 Q. So they didn't record either one?

11 A. No, sir.

12 Q. What about, did they record the loans?

13 A. Yes, they did.

14 Q. And how much was the total amount of sales that were not
15 recorded in Derivium's QuickBooks?

16 A. The stock receipts and sales, based on our records, stuff
17 we put in, I believe it was \$940 million. I think there is
18 some other detailed records that show it was close to a
19 billion dollars.

20 Q. Okay. Well, on page 29 you said it was over 800 million
21 of sales?

22 A. That's the actual loan amount.

23 Q. Okay. And in QuickBooks, I guess, could you open an
24 account for one of those brokerage statements and show the
25 sale there?

1 A. Yeah, you could. I'm going to make -- I don't have --
2 there is not an issue, is you could record it in a separate
3 database, but those transactions should be recorded on the
4 books and records, the receipt of that stock. It wasn't.

5 Q. Well, I guess what I'm trying to say is, is in
6 QuickBooks -- because that's what you are saying the books
7 and records are, right?

8 A. That's where they kept their general ledger books.
9 Right.

10 Q. I'm a solo practitioner and I use it. And God bless
11 Erica, she did mine.

12 My understanding is an activity -- you can set up an
13 account for that activity?

14 A. Yes, you can.

15 Q. Like if I'm going to pay you, Mr. Strickland, I can name
16 the account statement?

17 A. Yes.

18 Q. It can record payments to you and payments to me; is that
19 right?

20 A. That's right.

21 Q. And you put it all in the general ledger in QuickBooks,
22 as I understand it, and then you assign it in an account in
23 the general ledger?

24 A. Actually, QuickBooks goes through subsidiary ledgers.
25 And the subsidiary goes into the QuickBooks's general ledger.

1 Q. Does that mean if I pay a lot of accountants, I could
2 have a general description as accountants, and then
3 underneath it, and that number is ten, and then for each
4 account, like you could be 11, and then, you know, Mr. Nagy
5 is an accountant, he could be 12, so I could have the
6 subaccounts for accountants?

7 A. You could either -- you are talking about on the general
8 ledger? You could do it on the ledger in separate accounts,
9 but you could also do it in a subsidiary ledger and have it
10 booked into one account.

11 Q. From the whole ledger, the ledgers where you put in
12 everything, right?

13 A. It can be, or it can be -- the ledger can be generated
14 from the subsidiary registers.

15 Q. And then QuickBooks allows you to sort of slice and dice
16 information, if you will, like you want it?

17 A. Yeah. It's pretty flexible software.

18 Q. So you can pull out, like, a trial balance sheet off the
19 ledger?

20 A. Yes.

21 Q. You can pull off an income statement off the ledger?

22 A. Yes.

23 Q. And the Government gave you Derivium's QuickBooks, I
24 noticed on your Appendix C?

25 A. Yeah. We've got a, I think it's through 2004, the

1 QuickBooks database.

2 Q. Okay. And did y'all look at that stuff?

3 A. Yes, we did.

4 Q. And then some of the accounts that they use to sell the
5 stock in I think you listed in your report, but there was
6 like a J.C. Bradford account?

7 A. They had, um, various brokerage accounts.

8 Q. Do you recall J.C. Bradford being one?

9 A. Yes, I do.

10 Q. Paine Webber being one?

11 A. Yes.

12 Q. H.A. Edwards was one?

13 A. Yes.

14 Q. And then there was Morgan Keegan in Memphis?

15 A. There were a lot of brokerage accounts. I think we had a
16 total of 38.

17 Q. So in QuickBooks, you could open up an account in each
18 one of those if they were going to put it in?

19 A. Yes.

20 Q. If they opened up an account for that brokerage account,
21 they should have showed the sales in that, right?

22 A. Make sure I make this clear: They did not show the
23 receipt of the stock in that account.

24 When the client -- when the customer gave the shares
25 to Derivium on their books and records, just like you would

1 give a deposit to the bank, they didn't record that.

2 Q. Yeah, but I heard you say they didn't record the receipt
3 or sale of the stock?

4 A. The sale side of it was specific for that stock. They
5 showed the cash coming in, but they don't show the sale of
6 that stock.

7 Q. Yeah. But the cash coming in comes from the sale, right?

8 A. What they did is they debited cash and credited the
9 liability account. They skipped the whole section that the
10 stock came in and was sold.

11 Q. Well, I'm going to show you what I pulled out of what was
12 given to Mr. Nagy by his client at the end of the year. And
13 this is a 2001 trial balance?

14 A. Yes, sir.

15 Q. And it says Derivium LLC?

16 A. Yes, sir.

17 THE CLERK: What is that exhibit number?

18 MR. COOPER: It's a demonstrative.

19 THE COURT: That's not a demonstrative of anything.

20 MR. COOPER: It's of what their books and records --

21 MR. SEACORD: Your Honor, we are going to object to
22 this. It's not a demonstrative. It's clearly a document
23 that's not in the record.

24 THE COURT: A demonstrative is made by the lawyers.
25 That's not a demonstrative. I'll sustain the objection.

1 If you want to try to get it in evidence, that's
2 fine.

3 Q. You testified earlier that you were given Mr. Nagy's
4 records in the QuickBooks?

5 A. We were given a Derivium QuickBooks file, which I've
6 printed off various reports, yes. I don't know that I -- I
7 don't know that I have that specific item.

8 Q. But you were provided reports by the Government, what
9 documents were produced?

10 A. Yes.

11 MR. COOPER: Your Honor, I would like to move this
12 into evidence.

13 MR. SEACORD: We are going to object. There is no
14 foundation. I'm not even sure what that is.

15 THE COURT: Show it to him.

16 MR. CLUKEY: What exhibit number is that?

17 MR. COOPER: It's not listed.

18 THE COURT: Well, I think we were supposed to list
19 all the exhibits several weeks ago, I think.

20 MR. COOPER: I was going to use it to impeach him,
21 Your Honor.

22 MR. SEACORD: We are going to object on that ground,
23 as well. This clearly was not provided to us.

24 THE COURT: Sustain the objection.

25 MR. COOPER: Your Honor, may I talk to you at the

1 side bar?

2 THE COURT: Unless you can tell me that you've given
3 it to him before, identified it, which I don't believe you
4 have, I don't think you have any reason to do that.

5 MR. COOPER: The expert can rely on information
6 that's not in evidence.

7 THE COURT: You can't show it. It's not in
8 evidence. It doesn't go up there. If it's in evidence, you
9 can use it wherever you want.

10 MR. COOPER: May I hand it to --

11 THE COURT: Sure.

12 MR. COOPER: Thank you, Your Honor.

13 Q. Mr. Strickland, I've handed you what's Bates marked Nagy
14 75_8465.

15 And if you turn to the next page, 866, you go about
16 halfway down, do you see the section called long-term
17 liabilities?

18 A. Yes, I do.

19 Q. And then you see underneath it that it has the 2500 code
20 due BVL?

21 A. Yes.

22 Q. And then if you go to the bottom where it says 2501,
23 where it says broker activity?

24 A. Yes.

25 Q. Does that number read 800?

1 MR. SEACORD: I'm going to object again. Now he's
2 reading it into the record instead of showing it.

3 THE COURT: I'll sustain that.

4 Q. Does the document show \$800 million?

5 MR. SEACORD: Same objection, Your Honor. He's
6 still reading it into the record.

7 THE COURT: Sustained.

8 Q. Does the document show broker activity?

9 THE COURT: Every time you ask the question, "Does
10 this document show," he's going to object and I'm going to
11 sustain it, okay?

12 MR. COOPER: Thank you.

13 THE COURT: Okay.

14 Q. Did the books and records -- on the 2001 sheet, are there
15 broker accounts listed?

16 A. There is. There --

17 Q. And are there numbers next to the brokerage account?

18 A. Yes, there are.

19 MR. SEACORD: Your Honor, Mr. Cooper is determined
20 to get this in the record one way or the other. Now instead
21 of him reading it, he's having the witness read it.

22 So I'm going to object again.

23 THE COURT: I mean, experts can rely on things that
24 aren't in evidence; experts cannot read things that aren't in
25 evidence to the jury.

1 MR. COOPER: Well, I'm not asking him to read it.

2 THE COURT: You aren't? I must have missed
3 something.

4 All right. Maybe it's time to take an afternoon
5 break. You can go to your jury room and we'll talk about
6 this and then we'll be back with you in about 15 minutes.

7 (Thereupon, the jury retired from the courtroom.)

8 THE COURT: Okay. I mean, there are literally
9 thousands of documents. And I know you've got them lined up
10 in front of you. You've given them to me. Unless you
11 identify them ahead of time, you are supposed to swap
12 exhibits.

13 You can't pull something out of the air and say it's
14 a demonstrative. I mean, that's something that is in the
15 books and records of Derivium.

16 If you lay a foundation, you can get it in evidence
17 if you've identified it.

18 Now, what do you want me to do besides let you throw
19 it up on the screen? Which I'm not going to do unless you
20 give me a good reason for it.

21 MR. COOPER: Well, the reason is he relied on the
22 books and records given to him.

23 And my understanding is the Rules permit you with
24 the expert, even though it's not in evidence, because he can
25 rely on facts that are not in evidence as part of his

1 opinion. He relied on these books and records. I want to
2 ask him about it in coming to his opinion.

3 MR. SEACORD: Mr. Strickland's report, as well as
4 what he relied on, was provided to you many, many, many,
5 months ago. You've had -- you've had plenty of time to pour
6 over that and look through the exhibits and figure out which
7 ones he wants to use for this case and he didn't do it; and
8 instead, he brought -- picked one out and brought it here
9 today by surprise.

10 MR. COOPER: I don't think it's a surprise. He
11 relied on it and he testified about the books and records.

12 And secondly, he said it wasn't recorded in the
13 books and records, and it's clearly listed there on all the
14 brokerage accounts. And I think I've got to show it to him
15 to test the basis of his opinion.

16 MR. SEACORD: There are thousands and thousands and
17 thousands of pages of books and records of Derivium; all of
18 which were provided to Mr. Cooper, all the ones that
19 Mr. Strickland relied on.

20 If he had one that he wanted to ask Mr. Strickland
21 about, he could have picked it out and put it in his evidence
22 binder and marked it as an exhibit and provided it to us when
23 he was supposed to.

24 MR. COOPER: My understanding of the Rule is he can
25 testify as to issues not in evidence, and he said it wasn't

1 on the books and records. And I believe this document
2 demonstrates it is in the books and records.

3 Now I can use it for impeachment purposes to test
4 the basis of his opinion.

5 THE COURT: But you've got to identify them. Why --
6 why did you go through all this work identifying all these
7 exhibits and then your objections to them and all that?

8 MR. COOPER: We did do a lot of work.

9 THE COURT: I didn't say you didn't do a lot of
10 work; nobody is disputing that.

11 MR. COOPER: We get n here -- and the
12 understanding -- and you are preparing for it -- and my
13 understanding of the Rules is if he said that there -- they
14 didn't have it in their books and records, and there it is on
15 a balance sheet, I mean --

16 THE COURT: You may be able to get it in.

17 MR. COOPER: Expert impeachment.

18 In laying the foundation, he said that he reviewed
19 Mr. Nagy's documents and that's a Nagy Bates stamp and --

20 THE COURT: And that part of the Nagy Bates stamped
21 document was in the material that was given to you months
22 ago.

23 MR. COOPER: Yes, Your Honor.

24 MR. CLUKEY: Years ago, Your Honor.

25 THE COURT: Years ago.

1 All right. I mean, you may be able to get it in
2 with somebody else, you know, get them in with Mr. Nagy, but
3 not through this witness, unless you identified it ahead of
4 time.

5 Now, if you want to put that on your exhibit list
6 for Mr. Nagy today, you are welcome to do so.

7 MR. COOPER: Okay.

8 THE COURT: Okay?

9 MR. COOPER: So no impeachment with it either?

10 THE COURT: Nope. Unless you want to call him back,
11 unless you get it in evidence -- I mean, you know, y'all --
12 you know, y'all have been running this case yourselves. I
13 remember when this case came in, you were adamant to try it
14 in six or seven months, okay? And I said fine, we'll try it
15 in six or seven months.

16 And then you've cooperated, done what y'all were
17 supposed to do, and we scheduled it -- we scheduled it ahead
18 of time, you know, and things slip through. You can't use it
19 through this witness.

20 If you want to go through it with Mr. Nagy, that's
21 fine with me. He can come up and testify it was on the books
22 and records and Mr. Strickland doesn't know what the devil
23 he's talking about.

24 MR. COOPER: I understand. I thought it would be a
25 little more potent with him.

1 THE COURT: Potency, is that 1202? I guess potency
2 is a subset of relevancy, okay?

3 All right. How much longer -- we can take a break
4 now. Do you want to come back in -- what do you want to do?

5 Amy, what do you want?

6 The ruling is going to be the same on anything else.

7 MR. COOPER: No, I understand that.

8 THE COURT: Anything else before we bring the jury
9 in?

10 MR. COOPER: No, Your Honor.

11 THE COURT: I think your confusion would be looking
12 at Rule 703, which is the actual witness rule. It says:
13 "Facts or data that are otherwise inadmissible shall not be
14 disclosed to the jury."

15 So that's consistent. So we'll start again, all
16 right? Thanks.

17 (Thereupon, the jury returned to the courtroom.)

18 THE COURT: Okay. Mr. Cooper?

19 MR. COOPER: Thank you, Your Honor.

20 THE COURT: You are welcome.

21 Q. This is Exhibit 293 that IRS counsel used with you.

22 A. Yes, sir.

23 Q. And from here, from the depiction, um, was the sale of
24 the stock. Were the funds from the sale of the stock, those
25 very funds, used to pay for borrowers?

1 A. In some cases we could tie it in specifically. You would
2 see the stock, the stock sale, the cash coming in and the
3 transfer out. Sometimes it would be round -- it would be
4 rounded off, but usually, it would tie in pretty closely.

5 Q. But my question is: Was the sale and the proceeds from
6 the sale of the stock, was that used to fund the borrower's
7 money?

8 A. The cash was, yes.

9 Q. Was that done on every occasion?

10 A. Not -- if you had a -- somebody was refinancing sort of
11 thing, they would have to get the money out of whatever was
12 left, the ten percent, and it wasn't tied in.

13 Again, some transactions you could tie in real
14 clean, but this thing was really going full blast. There was
15 some fluidity of the account and then selling the stock.

16 Q. I'm going to hand you what was a chart in your report.

17 MR. SEACORD: Your Honor, I'm going to object to
18 this. This isn't in evidence.

19 MR. COOPER: They listed his report and the charts
20 in his report.

21 MR. SEACORD: His report was within the exhibit
22 binder for counsel only.

23 THE COURT: Is it marked into evidence?

24 MR. SEACORD: No.

25 THE COURT: Well, maybe you could get it

1 authenticated and we'll go from there.

2 Q. Would you mind looking at page 15 of your report, Your
3 Honor -- I mean, Mr. Strickland? And those are -- the charts
4 I handed to you appear in the report?

5 A. Yes, it does.

6 Q. And does -- is that report reflective of the report that
7 you sent to the Government in this case?

8 A. Yes, it does.

9 MR. COOPER: Your Honor, if I could move it into
10 evidence?

11 THE COURT: Is it marked with an exhibit number?

12 MR. SEACORD: I don't have any objection, but for
13 completeness, we might as well put his whole report in
14 evidence.

15 MR. COOPER: He's got a copy of it.

16 THE COURT: Mark that page as exhibit, whatever it
17 is.

18 What's the next one, Gail?

19 THE CLERK: Is that going to be yours, Mr. Cooper?

20 MR. COOPER: Yes, ma'am.

21 THE CLERK: Obviously. Okay. It would be Number
22 89.

23 THE COURT: In evidence.

24 MR. COOPER: Thank you, Your Honor.

25 (Thereupon, Defendant's Exhibit Number 89 was

1 received in evidence.)

2 Q. And I wanted to discuss what the report shows.

3 Does this reflect the analysis, or part of the
4 analysis you would have done for the J.C. Bradford account?

5 A. No.

6 Q. Is it reflecting a particular stock transaction that you
7 analyzed in your report?

8 A. Yes. This is relating to one of the specific examples,
9 the examples of the scenarios that I mentioned, and this is
10 the example of a loan renewal and the actual transactions
11 that occurred.

12 Q. And to tell the jury, on the top chart where you have the
13 date received, is that the date that the borrower transferred
14 the stock into the J.C. Bradford account?

15 A. That should be the date that -- what you have here is
16 you've got activity from three separate accounts.

17 Notice, this is early on. This is before this other
18 offshore lender account was created. These were all First
19 Security Capital, when everything was under one roof.

20 The first section is the Bradford account, which is
21 a brokerage account.

22 Second section is that same Bradford account.

23 And then the third is the First Union account, and
24 it shows the activity related to this transaction.

25 Q. Okay. And sticking with the columns, the date received

1 column, is that the day the stock was transferred into the
2 Bradford account?

3 A. Yes, that should be.

4 Q. And then moving to your right, the trade day, is that the
5 day that the stock -- the execution for the sale occurred?

6 A. That typically means the date that they put the trade in,
7 and then the settlement date, as I understand it, would be
8 the date that the cash would actually --

9 Q. Right.

10 So the cash came into the account on the settlement
11 day?

12 A. It would have come in on the -- right around the
13 settlement day, correct, when the trade was settled.

14 Q. And the gross proceeds minus commissions, that's the net
15 proceeds?

16 A. That's correct.

17 Q. And then if you go to the middle part of the chart there,
18 you are identifying when the cash was in, and your date is
19 down here, the 6-4, 6-7 and 6-8, are the total of the cash
20 that came in on those settlement dates, correct?

21 A. That's correct.

22 Q. So the cash didn't come in -- so 34,000 came in on 6-4?

23 A. Yes.

24 Q. And then the rest of the \$3 million came in subsequent to
25 that?

1 A. Yeah. It came in on -- at 3 million on June 7th, and
2 then 34,000 on June 8th.

3 Q. And then the money was wired out from the Bradford
4 account to the First Union account on 6-2 and then on
5 June 2nd and then on June 4th?

6 A. That's correct.

7 Q. And then --

8 A. To make sure you -- the -- there were securities on -- I
9 think this had a margin balance. They had to pay a margin
10 loan off. That was 6-2. You would have to do that in order
11 to settle the stock and then wire transfer out of
12 \$2.2 million.

13 Q. So I guess that's my first question, the first \$887,000,
14 that couldn't have been paid from the sale of that borrower's
15 stock because they had to pay it off first?

16 A. You have to pay it off in order to sell it. Really all
17 of these -- this happened -- came in on the 2nd, June the
18 2nd, and trade was executed, put in, it said, sell my stock
19 on June the 2nd.

20 In order to sell that stock, there was a related --
21 the client already had a loan out with a brokerage company.
22 He had to pay that loan off.

23 Q. Right.

24 So my question is: They couldn't have paid that
25 loan off from the sale of that borrower's stock?

1 A. No. Once this thing got up, they had flow in the
2 account, it was all related to the ten percent in all this
3 commerce money, just depending on the timing. Sometimes they
4 wouldn't be able to do that and sometimes they had the float
5 in there.

6 Q. And looking to the middle chart, because they transferred
7 out the 2.2 million into the First Union account, and then
8 from the First Union account it went to the borrower,
9 correct?

10 A. Yes.

11 Q. So the 2.2 million had to be paid out of a different
12 source of funds to be transferred into the First Union
13 account?

14 A. Yes. It was all in the same pot.

15 Q. But the 2.2 couldn't have been the borrower's money
16 because it was transferred out before the cash came in on the
17 7th and 8th?

18 A. Right.

19 What they did was put the trade in on June the 2nd.
20 It takes them a little while to actually execute the trade.

21 Once you put the trade in; it's accepted, they are
22 going to get the cash on a settlement date. So you basically
23 use someone else's money to put the 2.2. They didn't have
24 any of their own money, it all had to come from the ten
25 percent. I don't know whose money this is. It's somebody

1 else's money.

2 Q. You mentioned that there was a lender, Bancroft Ventures
3 Ltd., correct?

4 A. Supposedly an entity, unrelated lender, correct.

5 Q. So -- but let's not use Bancroft. What happens --

6 A. Can I expand on that?

7 In this transaction, there is no lender. This is
8 all happening -- these are all Derivium accounts. This is
9 before they put in this supposed offshore lender.

10 Q. But when there was a lender, let's just -- when the
11 lender was there, Bancroft, if it was a real lender, couldn't
12 the money come from a lender's capital, other capital
13 resources?

14 A. If they had capital. But the activity -- we had the
15 Bancroft statements. Nothing really changed that we could
16 tell; they just added another name of a company.

17 Q. That's what I'm driving at. Bancroft is, I believe Mr.
18 Clukey said, was located in the Isle of Man, but that was his
19 jurisdiction, somewhere in the U.K. over there?

20 A. Yes.

21 Q. So -- and real banks are in the U.K., like Abbey over
22 there?

23 A. Yeah. There is plenty of banks over there.

24 Q. And you know the Royal Bank of Scotland is over there?

25 A. Yes.

1 Q. So even though there could have been an account for the
2 Royal Bank of Scotland, they could have capital reserves over
3 there in the U.K. to pay that loan with, couldn't they?

4 A. There was no evidence that we could find from day one to
5 the end of any cash coming in from any other source other
6 than the ten percent. We didn't see any evidence of that.

7 Could they have capital? I guess they could. We
8 didn't see any evidence. The money that was used -- the only
9 money they had to use was the float on these customers'
10 accounts, this lag between when they received the cash and
11 paid the cash to the customer and the ten percent that they
12 retained, that's the only money they had that we could tell.

13 Q. And you don't know if it was represented to Mr. Nagy
14 about the lender? Do you know?

15 A. It's --

16 Q. By Mr. -- Dr. Cathcart?

17 MR. SEACORD: I'm going to object on hearsay
18 grounds.

19 THE COURT: Overrule that objection.

20 You can answer that question.

21 THE WITNESS: No. Oh, you mean Mr. Nagy's
22 deposition?

23 THE COURT: No. The question was: "You don't know
24 what was represented to Mr. Nagy by Dr. Cathcart?"

25 THE WITNESS: Other than reading what he, Mr. Nagy

1 mentioned in his deposition, no, sir.

2 Q. And if you will turn to page 18 of your report.

3 MR. SEACORD: Your Honor, I'm going to have the same
4 objection.

5 THE COURT: Go ahead and authenticate it and we'll
6 go from there.

7 Q. And does the chart I just handed you appear on page 18 of
8 your report?

9 A. Yes, sir.

10 MR. COOPER: Your Honor, may I publish it to the
11 jury?

12 MR. SEACORD: I'm still going to object. He hasn't
13 established the authenticity.

14 THE COURT: Okay. Go ahead and ask him the
15 questions about -- first put a number on it.

16 I guess it's 90. Would that be right, Gail?

17 THE CLERK: Yes, sir.

18 MR. SEACORD: As long as it's numbered with an
19 exhibit, I'll withdraw my objection.

20 THE COURT: Okay. So Exhibit 90 in evidence without
21 objection.

22 (Thereupon, Defendant's Exhibit Number 90 was
23 received in evidence.)

24 THE CLERK: Do you need a sticker? Thank you.

25 Q. And again, the -- sort of the same analysis we did

1 yesterday -- not yesterday, it feels like yesterday, but just
2 a second ago -- that you traced the funds from the receipt of
3 the First Union account?

4 A. The receipt into the First Union account, again, this is
5 the First Security Capital account.

6 Q. And then below, you again show when the cash is in and
7 when is the cash out, and it's transferred into the bank
8 account at First Union?

9 A. That's correct.

10 Q. And so here the settlement day is 3-2 on your top chart?

11 A. That's correct.

12 Q. And the wire into the First Capital account is also on
13 3-2, correct?

14 A. Which wire? Excuse me.

15 Q. The cash out of the First Union Securities account --

16 A. That's correct.

17 Q. -- also happened on 3-2?

18 A. Yes.

19 Q. And if you go to the bottom, the proceeds were sent to
20 the borrower on March 1st, correct?

21 A. That's correct.

22 Q. So again, Derivium funded the borrower's loan from funds;
23 not from the sale of the stock?

24 A. As you can see here, they had -- this \$300,000, you can
25 tie each one of these in. There is no activity in these

1 accounts, other than these transfers.

2 There were other loans, if you go in here, that make
3 up that they had to pay for it, that same timeframe. That's
4 why the balance is \$300,000, but it's the same -- same issue.

5 Q. If you go to Exhibit 4 of your report, and I tried to tab
6 it for you to speed things up, and it's the account statement
7 for First Union?

8 A. Yes.

9 Q. And was this bank account part of your report?

10 A. Yes. It's an exhibit.

11 Q. Okay. Was it something you relied on?

12 A. It's one of the bank accounts that I relied on, yes.

13 MR. COOPER: Your Honor, may I publish it to the
14 jury?

15 THE COURT: That would be 91?

16 MR. SEACORD: Can I see it first?

17 I don't have any objection.

18 THE COURT: 91 into evidence. Then you can publish
19 it to the jury.

20 (Thereupon, Defendant's Exhibit Number 91 was
21 received in evidence.)

22 Let Gail put a sticker on it so Gail won't lose it.

23 Q. And the transaction out to the borrower happened on
24 March 2nd, which is the highlighted 88,000?

25 A. That's correct.

1 Q. And this shows that they had a \$529,000 balance as of
2 March 1st in the account?

3 A. Yes. That's correct.

4 Q. And then below, I believe I've highlighted, as well,
5 where you showed the 300,000 coming in?

6 A. That's correct.

7 Q. And the 300,000 came in after the money was sent to the
8 borrower?

9 A. Yes. That's exactly right.

10 Q. So it couldn't have been funded from the sale of that
11 borrower's stock?

12 A. If you look at this over time, the only source of funds,
13 in my opinion, yes, it was funded from that sale of that
14 stock. If you -- there was enough, unless they happened to
15 have extra money in there.

16 The only -- the only place they were able to get
17 money was the ten percent, okay? So the only activity you
18 had in here -- no one else put any money in. The only source
19 of funds with this statement was the sale of somebody's
20 stock. In a lot of them, you could tie in exactly. This is
21 one that you can't tie in exactly.

22 Q. It's one of the examples that's in your report, right?

23 A. It's one of the statements. That's correct.

24 Q. So my question is narrower than the one you just answered
25 because the money was transferred out from the borrower

1 before the 300,000 came in, the payment to that borrower
2 could not have been from the sale of that borrower's stock?

3 A. It wouldn't have been from that 300,000.

4 But the source for that payment came from the sale
5 of the borrower's stock. That's the only thing they had.

6 Q. I mean, how could -- if it went out on 3-1 to the
7 borrower -- and you just said the settlement day was when the
8 cash came in -- how could it be from that borrower's stock?

9 A. It's in the end, the timing of all of this that we talked
10 about this, but there is no other source of funds but that
11 borrower's stock.

12 Q. And back to Exhibit 91.

13 Do you know why you picked the 300 instead of the
14 260? I mean, the 260 is closer to the 88 than the 300.

15 A. We just picked -- we could have picked hundreds of
16 examples. We just happened to pick these. No particular
17 reason. There were hundreds and hundreds of examples.

18 MR. COOPER: I'm going to hand the witness pages 21
19 through 24.

20 THE COURT: Of his report? Why don't you get a
21 sticker up front.

22 MR. COOPER: Yes, Your Honor.

23 THE COURT: 92?

24 THE CLERK: Yes, sir.

25 THE COURT: Show it to Mr. Seador before you put it

1 into evidence to make sure he knows what we are talking
2 about.

3 MR. COOPER: Yes, Your Honor.

4 MR. SEACORD: I have no objection.

5 THE COURT: Okay. In evidence. You can show it.

6 (Thereupon, Defendant's Exhibit Number 92 was
7 received in evidence.)

8 Q. Are you ready?

9 A. Yes.

10 Q. Okay. The question here is the same, if you look at the
11 bottom chart, it went out to the borrower on May 3rd --
12 April 3rd?

13 A. Yes.

14 Q. And the money didn't come into the bank account on your
15 chart until April 4th?

16 A. That's correct.

17 Q. And the same question: Because the money went to the
18 borrower the day before, according to your chart, it couldn't
19 have been funded from the proceeds of that borrower's stock?

20 A. Make sure you understand. We took every brokerage
21 statement, and the only thing you have on the brokerage
22 statements is the stock coming in, the stock being sold, and
23 that money being transferred in one of these accounts.

24 In many situations, you could tie it in exactly, but
25 there was no other source of money at the beginning of the

1 month. You can roll each one forward and tie each one into a
2 loan.

3 And when you have these bulk transfers, what is
4 happening is, the money is coming into the brokerage account,
5 but they might have two or three loans to fund. Stocks come
6 in, they've sold it and they are moving it over in a bulk
7 amount. It's the same money.

8 Q. Well, how could it be the same money if the money is not
9 even there yet?

10 A. It might not be the exact same dollar bill, but it's the
11 same source of funds. There is no other source of money
12 other than the sale of the securities.

13 Q. Now, Mr. -- Mr. Strickland, you didn't -- you are not
14 giving an opinion on Mr. Nagy's tax advice, are you?

15 A. No, sir.

16 Q. Did the Government lawyers tell you that Mr. Nagy told
17 the IRS the stock was sold?

18 A. I don't know that they told me that, no. I think -- I
19 don't know.

20 MR. COOPER: That's all I have.

21 REDIRECT EXAMINATION

22 BY MR. SEACORD:

23 Q. I just have a couple of questions for you,
24 Mr. Strickland.

25 Mr. Cooper showed you a series of charts, this one

1 has been marked Exhibit 90, he showed you a series of these,
2 and I just want to make sure the jury understands.

3 This isn't an actual statement from Derivium, is it?

4 A. No. See, we took this -- we had hundreds of monthly
5 brokerage statements.

6 We looked at -- like I said, we looked at, I think
7 it's \$940 million worth of these transactions, these stock
8 transactions. And what we were trying to do in our report is
9 just give three examples of exactly how it worked.

10 And the way it worked is the stock came in, they
11 sold the stock and they gave the customer ninety percent;
12 they kept ten percent.

13 And as I already mentioned, that ten percent was
14 used for the operating cost to fund the startups and if they
15 had to pay money on these loans. They didn't have a hedge.

16 So we went in -- we could have picked -- there is
17 hundreds of transactions we could have picked. I could have
18 found, I'm sure, plenty that tied in exactly.

19 What I want you to understand is there was no other
20 source of money, and it flows -- each one we were able to
21 flow it right on through the transaction.

22 Q. And when that money comes in, where does it go? Does it
23 all go into the same account?

24 A. The money -- the securities would go into a brokerage
25 account, and in these early days, they didn't have all these

1 other entities; it was all First Security Capital.

2 Q. If I could just stop you right there.

3 Who is First Security Capital?

4 A. First Security Capital is the company that they started
5 out before Derivium. They had First Security Capital, and
6 some things happened and the name changed in the structure.
7 They started doing these offshore companies.

8 Q. I'm sorry I interrupted you. You were talking about
9 where the funds go.

10 A. They go into the brokerage statement. They sell it and
11 then they transfer the money out of the brokerage statement
12 into an operating account that they would then cut a check to
13 the customer.

14 Q. And so it all goes into the same pot, and if they need to
15 they pay out of the pot from the sale of securities?

16 A. Yes. The key is it's all the same pot, but it's all
17 coming from the same source, is to sell the stock.

18 MR. SEACORD: I don't have any other questions.

19 MR. COOPER: I don't have anything else.

20 THE COURT: Thank you, Mr. Strickland.

21 MR. SEACORD: Before Mr. Strickland leaves the
22 stand, I just have an evidentiary question for him.

23 THE COURT: Sure.

24 MR. SEACORD: This just relates to his report, and if
25 Your Honor will allow me I'll hand his report to him.

1 THE COURT: Sure.

2 Q. If you could take a look at that binder, Mr. Strickland,
3 and take a look at your expert report that you prepared in
4 this case, do you see it there?

5 A. Yes.

6 Q. And is that the report that you prepared after you looked
7 at the books and records of Derivium?

8 A. Yes.

9 Q. Does that appear to be an accurate copy of your report?

10 A. Yes, it does.

11 Q. And the page -- the charts and things that Mr. Cooper was
12 putting up here on the Elmo, were those specific pages within
13 your report?

14 A. They were just certain pages.

15 MR. SEACORD: Your Honor, at this time I would move
16 Mr. Strickland's entire report into evidence.

17 THE COURT: Any objection?

18 MR. COOPER: No, Your Honor.

19 THE COURT: Okay. In evidence.

20 MR. SEACORD: Thank you. That's all.

21 THE COURT: I guess we ought to get a number.

22 THE CLERK: What is that number?

23 MS. WEIS: 259.

24 THE COURT: Thank you.

25 (Thereupon, Government's Exhibit Number 259 was

1 received in evidence.)

2 MR. SEACORD: Actually, his report is only a small
3 part of that, so I can just take it out.

4 THE COURT: All right. I'll give that to you and
5 you can gave it to Gail or whatever.

6 MR. SEACORD: Thank you, Your Honor.

7 THE COURT: Anything else? Mr. Strickland is
8 excused?

9 MR. SEACORD: Yes, he's excused.

10 THE COURT: Good. Thank you.

11 Yes, ma'am?

12 MS. WEIS: Your Honor, the Government calls as its
13 next witness, Patrick Kelly.

14 THE COURT: Mr. Kelley, do you want to come up and
15 be sworn for me?

16 THE CLERK: Place your left hand on the Bible and
17 raise your right hand.

18 State your name for the record.

19 THE WITNESS: Patrick Russell Kelly.

20 THEREUPON:

21 MR. PATRICK RUSSELL KELLY,
22 Called in these proceedings and having been first duly sworn
23 testifies as follows:

24 THE CLERK: Thank you. Be seated on the witness
25 stand.

1 DIRECT EXAMINATION

2 BY MS. WEIS:

3 Q. Mr. Kelley, can you see that demonstrative?

4 A. I can barely hear you. I can see this.

5 Q. I'll do my best to speak up.

6 MR. COOPER: If need be, can I move?

7 THE COURT: Sure. You can go anywhere you want to.

8 No problem.

9 MR. COOPER: Thank you.

10 Q. Mr. Kelley, do you know this gentleman, Robert Nagy?

11 A. Yes, I do.

12 Q. How do you know him?

13 A. I know him from my association with Derivium Capital.

14 And I'll use that to -- for the different entities, if that's
15 okay.

16 Q. That was my plan.

17 So when you say "the different entities," what was
18 the name of Derivium when you first started working there?

19 A. When they hired me, it was First Security Capital.

20 Q. And then I assume it changed its name to Derivium?

21 A. It did. It changed its name to Derivium.

22 Q. After that, did you work for a Derivium company that had
23 a different name? When you say "Derivium," you are referring
24 to the various entities?

25 A. I only worked for Derivium Capital then, because I worked

1 in the back office operations. That company was separated
2 and the people here in Charleston started to work instead for
3 Veridia.

4 Q. Okay. So you worked for FSC, Derivium and then Veridia?

5 A. That's correct.

6 Q. Now, you said that when you were started, when you were
7 hired, it's called FSC. Do you remember what year you were
8 hired by FSC?

9 A. I think it was 1999.

10 Q. And was this a new position that was created for you or
11 did you replace someone else?

12 A. I replaced someone else.

13 Q. What was that person's name?

14 A. Jonathan Sandifer.

15 Q. How long did you work for Derivium, as we call the
16 companies?

17 A. Well, I don't remember the exact year, but I stopped
18 working for Derivium and started working for Veridia, but I
19 think it was maybe around 2001.

20 So I probably worked for First Security Capital and
21 then Derivium from 1999 to 2001 and then started working for
22 Veridia.

23 Q. How long did you work for Veridia?

24 A. Um, I think it was late 2005 or maybe just the beginning
25 of 2006.

1 Q. When you were at all three companies, FSC, Derivium and
2 Veridia, did you have an immediate supervisor?

3 A. Yes, I did.

4 Q. What was his or her name?

5 A. Yuri Debevc.

6 Q. And he was your immediate supervisor the entire time you
7 were with those three companies?

8 A. That's correct.

9 Q. Now, you said that you worked in the back office; is that
10 correct?

11 A. Correct.

12 Q. Could you give the jury sort of the 30,000-foot view of
13 what that entails?

14 A. Okay. The -- a back office, or our financial services
15 firm was, we dealt with a client, a borrower after they had
16 decided that they wanted to take out a loan and made sure
17 that they signed their contracts. We helped them transfer
18 the stock from their accounts to our brokerage accounts.

19 We managed the database that tracked all of their
20 transactions during the time that they were a client, and
21 then we sent out the reports at the end.

22 So sort of, you know, nuts and bolts kind of stuff.

23 Q. Thank you.

24 Did Veridia or Derivium, when you were working,
25 whatever it was called, provide services to any other

1 companies?

2 A. Um, I'm not sure what you mean. We had several vendors.

3 Is that what you mean?

4 Q. Yes. What were those called?

5 A. Well, let's see, I was aware of -- and looking at this is
6 a little bit helpful -- DDA, um, Bancroft, WITCO and Optech.

7 Q. Now, Mr. Kelley, when you first began at FSC, how many
8 people worked in the back office with you?

9 A. Um, there was three of us.

10 Q. You, Yuri Debevc?

11 A. And, gosh, I don't know, it was our secretary and an
12 assistant. And at the moment, I don't remember her name.

13 She didn't work for very long, but there was --

14 Q. A third person?

15 A. A third person.

16 Q. I assume the office got bigger at some point?

17 A. It did.

18 Q. At its height, how many people worked in the back office?

19 A. I think we probably had at least nine, 12 people.

20 Q. And at the very end when you ended your employment with
21 Veridia, how many people were working in the office at that
22 time?

23 A. Just Yuri and I.

24 Q. And I don't remember if I asked you this before, do you
25 remember what year it was when you stopped working at

1 Veridia?

2 A. Um, I think it was either late 2005 or early 2006.

3 Q. Now, Mr. Kelley, you worked with Yuri Debevc, it sounds
4 like, for seven years, plus or minus?

5 A. Yes.

6 Q. And would you consider him a friend of yours?

7 A. Yes.

8 Q. Do you still keep in touch with him now that you don't
9 work at Veridia?

10 A. I do.

11 Q. How often do you keep in touch with him?

12 A. Um, he doesn't live in Charleston anymore, but if he
13 comes into town, then we'll try and have breakfast or
14 something like that.

15 Q. Have you been sued because of the work that you did at
16 Veridia?

17 A. Yes, I have.

18 Q. And you are currently being sued?

19 A. I am.

20 Q. Not by the United States; is that correct?

21 A. No.

22 Q. Now, you also said that you met Mr. Nagy through your
23 work at Derivium; is that correct?

24 A. Yes, I did.

25 Q. Of the seven or so years that you were at

1 Derivium/Veridia, how many years do you associate Mr. Nagy
2 being there, as well?

3 A. I couldn't tell exactly, but very early in the time when
4 I started working there. So I would think it was 1999 or
5 2000.

6 Q. And was he there throughout the entire time after that?

7 A. Certainly into 2005. Um, I don't remember at the very
8 end whether he was -- um, whether we were working or whether
9 he was generating reports.

10 Q. During your time at Veridia and Derivium, I assume there
11 were sort of work events out of the office, happy hours,
12 Christmas parties; that kind of thing?

13 A. That's correct.

14 Q. Did Mr. Nagy attend some of those?

15 A. Yes, he did.

16 Q. Do you still keep in touch with Mr. Nagy?

17 A. It's a small town. We see each other, but I have no
18 business dealings with him.

19 Q. When you came in the courtroom today, did you say hi to
20 Mr. Nagy?

21 A. I did.

22 Q. You visited with him?

23 A. Yes.

24 Q. Would you consider yourself on friendly terms with Mr.
25 Nagy?

1 A. Oh, certainly friendly terms, yes.

2 Q. Now, when you were at Derivium and Veridia, what was the
3 nature of your contact with Mr. Nagy?

4 A. Um, Mr. Nagy would help us in creating reports if -- for
5 instance, making sure that we properly recorded any tax
6 events that a client would need to know in regards to their
7 loan, and also help us in making sure that the information
8 that we pulled out of our database for, like month-end
9 reports and such, you know, he might ask for some specific
10 information.

11 Q. So when you say that you help in creating reports for
12 clients when they had tax events, what kind of reports are
13 you talking about?

14 A. Specifically, we would send out a report at the end of
15 the year that would let the client know whether they had
16 any -- that would help them file their taxes in regards to
17 their loan and performance of their, either the loan or the
18 stocks that were held in there.

19 Q. What kind of information would be contained in these
20 reports?

21 A. Um, things as to whether -- for instance, a company might
22 have to pay dividends and -- I'm not an accountant -- I
23 understand there is different types of dividends; therefore,
24 when they reported it on their taxes, they would need to
25 produce it.

1 Q. Now, the dividends that you were reporting to the 90%
2 Loan customers --

3 A. Yes.

4 Q. -- they would be submitted as stock for collateral; is
5 that correct?

6 A. That's correct.

7 Q. But you worked in the back office?

8 A. I did.

9 Q. So would you agree that the -- with Mr. Strickland's
10 testimony that the stock was sold when each customer ends the
11 transaction?

12 A. That was the start of the hedging process, as explained
13 to us. And, you know, we would sell the stock and establish
14 a value for that client's portfolio, that borrower's
15 portfolio on the day they submitted it, if possible to do
16 that.

17 Q. So when you sent out the annual statements to the
18 customers for the dividends that were received on the stock,
19 those dividends weren't actually received by Derivium; is
20 that correct?

21 A. That's correct.

22 Q. How did you find data you put in the reports about the
23 dividends of those stocks?

24 A. We would use such things as Standard & Poor's, we would
25 sometimes use Bloomberg. We would use different companies

1 that would provide this information to us.

2 Q. So you needed to look up that information because the
3 companies themselves, the stock companies, weren't providing
4 that information to Derivium correctly; is that correct?

5 A. That's correct.

6 Q. And who helped you find that information in Standard &
7 Poor's?

8 A. At times, Mr. Nagy. Um, at times it was whatever firm we
9 worked with. If we worked with Bloomberg, then we might work
10 with Bloomberg's own personnel.

11 Q. Now, you mentioned that there was data that you would
12 pull from databases to provide to Mr. Nagy on occasion?

13 A. Yes.

14 Q. What kind of data would he request from you?

15 A. Um, we would -- at the end of each month, we would submit
16 to the owners a report of all the activity that had gone on
17 during the month. If we worked with borrowers and we had
18 done loans, we would sum all of this up into one or two
19 pages.

20 So rather than let them having to look at all the
21 transactions, they would look and see, you know, what
22 activities the business had had during that month.

23 So it might reflect loans, stock opinion, loans, I
24 mean, there is a big report. I can keep going.

25 Q. Please do.

1 A. Okay. There would be collateral values for existing
2 loans, and what the loan value -- say, if I had done a loan a
3 year earlier and there was two more years to go on the loan,
4 then you might say, okay, the loan today, they owed this
5 amount of money.

6 Q. Now, when you say "the collateral values," that was how
7 much -- well, could you explain what that was?

8 A. Yes.

9 As explained to us, the client retained what they
10 call beneficial ownership of their stocks. So if we reported
11 that a client had a loan, say, of \$100,000, then the stock
12 since the beginning of the loan may have gone up or gone
13 down.

14 And that value would be reported on this, so that
15 you would know whether the collateral that the clients owned
16 was more or less than the value of the loan at that
17 particular time.

18 Q. So the -- you were tracking basically how much this --
19 the value of the stock that was sold initially, but had
20 been -- had changed since the loan transaction began?

21 A. Correct.

22 Q. And Mr. Nagy got copies of those reports?

23 A. Um, I'm not sure. He was on our monthly distribution,
24 but no question at times he would contribute to whether we
25 were creating the reports correctly.

1 I responded to him like I might respond to an
2 accountant who would say, you know, you are not doing things
3 correct, because I'm not an accountant, so I would take his
4 documents, yes.

5 Q. You got his guidance on how to create these reports to
6 get to the owners of the company; is that correct?

7 A. Well, I did the actual creation of the reports, but he
8 might guide me as to whether I was getting right -- you know,
9 whether he would ask me questions about was I getting right
10 data out of it so that it would be reported correctly, I
11 assume.

12 Q. Now, when you say "owners of the company," who are you
13 talking about?

14 A. Well, Dr. Cathcart and Scott Cathcart, and then certainly
15 Bob Brandenburg would get a copy of the reports, and Yuri
16 would get a copy of the reports.

17 Q. Bob Brandenburg, he was an accountant for that company?

18 A. He was an accountant also.

19 Q. Was he an owner of the company?

20 A. Not that I'm aware of.

21 Q. Did Mr. Nagy, that you recall, request any other types of
22 data for you to pull out of the database?

23 A. I'm sure he did. You know, we would correspond, and my
24 direction was that I could respond to either Mr. Brandenburg
25 or Mr. Nagy. You know, if they had an accounting question,

1 I -- there was only a couple of us that could get reports out
2 of the database very well. So they would -- we had
3 permission to, you know, generate a report, a requested one.

4 Q. It was reasonable always to give them that report if they
5 requested it?

6 A. Yes. We had permission to, you know, give them the
7 report.

8 Q. How often did Mr. Nagy request reports from you?

9 A. Not -- not that often, I mean -- but I couldn't say --
10 you know, it was just one of those things. We would respond
11 to, you know, whichever of the accountants asked questions.

12 Q. Now, since we are talking about sort of an accounting
13 role, did you ever work with Mr. Nagy to set up company
14 accounts and invoices to make sure that the companies'
15 paperwork was being generated correctly? Invoices, for
16 example?

17 A. Um, I don't think so. You mean like general ledger or
18 accounting reports, a business might --

19 Q. Let's go a step back.

20 A. Okay.

21 Q. So Derivium had a server in Canada; is that correct?

22 A. That's correct.

23 Q. And the server was just to maintain data from its
24 computer files?

25 A. Yes. Correct.

1 Q. And there was a third party that, you know, provided
2 services to Derivium to maintain that server; is that
3 correct?

4 A. Right.

5 We had a small technology firm that could make sure
6 that it kept working, yes.

7 Q. IT team?

8 A. IT team, yes.

9 Q. Now, did you work with Mr. Nagy in making sure that the
10 invoices that IT provided to Derivium were correct?

11 A. Certainly.

12 I mean, you know, from the standpoint of making sure
13 that, you know, if Derivium was -- how to phrase this --
14 since we used the servers, you wanted to make sure that we
15 were billed properly for them. I'm not sure I'm answering
16 the question correctly.

17 Q. No.

18 A. Okay.

19 MS. WEIS: May I approach the witness?

20 THE COURT: Sure.

21 MS. WEIS: I'm going to be handing the witness what's
22 been previously marked for identification as Government 339.

23 THE COURT: Okay.

24 Q. Mr. Kelley, take a minute to look at that and let me know
25 when you are done.

1 A. Yes.

2 Q. Now, if you look down at the very bottom, Mr. Kelley, do
3 you see an e-mail address?

4 A. Yes.

5 Q. Is that your e-mail address?

6 A. It is.

7 Q. And if you look at the date at the top, is that a date
8 that you were working at Derivium?

9 A. Yes.

10 Q. Is this the kind of e-mail that you would be sending in
11 the course of your duties as part of your employment with
12 Derivium?

13 A. Yes.

14 MS. WEIS: Your Honor, at this time we would move
15 into evidence Government Exhibit 339.

16 MR. COOPER: 402. 403.

17 THE COURT: Overruled.

18 THE WITNESS: What's that?

19 THE COURT: In evidence.

20 MS. WEIS: 339.

21 (Thereupon, Government's Exhibit Number 339 was
22 admitted in evidence.)

23 Q. If you just sort of zoom in on the entire e-mail.

24 So Mr. Kelley, that's your name and address, e-mail
25 address at the top --

1 A. Yes.

2 Q. -- is that correct?

3 THE COURT: Wait, Ms. Weis. If y'all can't see it,
4 you let us know, we can blow it up some more. As long as you
5 can see it, just -- if you can't see anything, raise your
6 hand to make sure you see it, okay?

7 Thanks. Go ahead.

8 Q. And the subject is network accounting; is that correct?

9 A. I'm sorry?

10 Q. The subject of the e-mail is network accounting?

11 A. Yes.

12 Q. All right.

13 A. To my point of view, it's dealing with technology.

14 Q. Okay.

15 A. Okay.

16 Q. So this is the sort of thing that we would -- we were
17 talking about invoices, setting up accounts and paperwork so
18 that it will be clear that the equipment is owned by Derivium
19 and not by First Security Capital of Canada?

20 A. Right.

21 You know, the technology part is, you know, probably
22 the only thing that I deal with, but you know, I dealt with
23 invoices with technology.

24 Q. And you talked with Mr. Nagy about those invoices?

25 A. Or Bob Brandenburg --

1 Q. Okay.

2 A. -- either one of those two.

3 Q. So up at the beginning -- actually I have a question.

4 Do you see where it says, "Charles, per our
5 conversation regarding technology invoices that relate to the
6 Hamilton location" -- what's the Hamilton location?

7 A. That's -- the servers were in Canada and Hamilton was --
8 is a small town just outside of Toronto. And that's where
9 the people that worked with First Security Capital and our
10 technology, the people who were maintaining the servers,
11 that's where their office was.

12 Q. And First Security Capital Canada, was that in some way
13 affiliated with Derivium or FSC?

14 A. Had the same name. The person that was up there I had
15 met through Dr. Cathcart, so I had to go out there, see what
16 its relationship was.

17 But obviously, it had to be related from that
18 standpoint. And, you know, it was -- and that was who I
19 would see when I would go up there.

20 Q. So I, just for the jury's reference, FSC Canada down
21 here, I'll be talking about that same --

22 A. Okay.

23 Q. Mr. Kelley, do you see down three lines, the last big
24 paragraph, and it says: "This also gives us paper trails to
25 show ownership"?

1 A. Yes.

2 Q. Do you recall what you were referring to when it says,
3 "This also gives us paper trails to show ownership"?

4 A. From an accounting standpoint, you know, I don't -- I
5 don't want to have something and not be able to show, you
6 know, how it -- how it occurred, how you acquired it.

7 And you don't want, you know -- these servers were
8 in Canada, so you don't want to not record it down here
9 because we didn't have these servers down here anymore. So
10 you wanted to still show that, you know, this is part of the
11 business, so you want to make sure that you have a paper
12 trail.

13 Q. Okay. Thank you.

14 Just one other question, it says CH. Who is CH?

15 A. He's the person that was at First Security Capital of
16 Canada. He's the person that, you know, if he was in town, I
17 would see him.

18 Q. Do you know what his -- what the CH stands for?

19 A. Um, actually -- um, well actually, I think the C stands
20 for Charles, but all I recall was CH.

21 Q. What was Charles's last name?

22 A. It's Hsin, H S I N, or something. I'm probably murdering
23 it, the pronunciation.

24 Q. That's all I have for 339.

25 Now, Mr. Kelley, if a customer called Derivium and

1 had a question about, you know, the taxes, for instance -- at
2 the end of the year they had a question about the taxes,
3 their taxes, was there a person that Derivium could direct
4 them to, a go-to person?

5 A. Depending on, you know, what questions they asked, yes,
6 we could. Um, Bob -- yeah -- I'm sorry -- both Bobs -- too
7 many Bobs -- but Bob Nagy on occasion, you know, would talk
8 to a client because we knew that he had done research on it
9 and had helped us in creating the year-end report to make
10 sure that the clients could report, you know, the -- what was
11 happening with their loan properly.

12 So we did not use him -- just because a client asked
13 a question, we didn't automatically send them to Bob, but he
14 was a resource that we had.

15 Q. And when you were working at Derivium, you had staff that
16 is -- would you say you had staff underneath you that you
17 were more senior to?

18 A. Yes.

19 Q. And you could pass on instructions to them about -- for
20 instance, you know, whether or not to use Mr. Nagy as a
21 resource for a topic?

22 A. That's correct.

23 MS. WEIS: At this time I would like to approach the
24 witness again.

25 THE COURT: Sure.

1 MS. WEIS: I handed the witness what's been
2 previously marked for identification as 153.

3 Q. Would you take a look at 153 and let me know when you are
4 done?

5 A. Okay.

6 Q. Mr. Kelley, if you look down at the very bottom, you see
7 an e-mail address?

8 A. I do.

9 Q. That's your e-mail address?

10 A. That's mine.

11 Q. And again, I understand the format is a little bit
12 different on this one. If you look at the top, you can find
13 a date, and working at Derivium, December 24, 2002?

14 A. Yes.

15 Q. And looking at this e-mail, do you generally recognize
16 the subject matter of this e-mail?

17 A. Yes.

18 MS. WEIS: Your Honor, at this time I would move for
19 admission into evidence Government Exhibit 153.

20 MR. COOPER: No objection.

21 THE COURT: In evidence.

22 (Thereupon, Government's Exhibit Number 153 was
23 received in evidence.)

24 MS. WEIS: So Sam, if you could just blow up the
25 body of the text and then the signature.

1 Q. So Mr. Kelley, is this an e-mail that you sent to the
2 other employees in the back office at Derivium?

3 A. Certainly some. I don't know if it went to all of them,
4 but it definitely went to some of the people there.

5 Q. And if you see in the, I guess it's the fourth paragraph
6 where it says: "Bob will be able to give some background on
7 his research in this area"?

8 A. Yes.

9 Q. Is this Bob Nagy that you are referring to?

10 A. It is Bob Nagy.

11 Q. And then it says: "But again, I don't think even Bob
12 would be giving tax advice. I think he mainly gives them
13 guidance as to what codes and tax advice is typically to our
14 product."

15 Is that your understanding in Mr. Nagy's role in
16 discussing tax consequences with customers?

17 A. Yes, that's correct. Generally speaking, according to
18 what the market told us, they would usually direct the client
19 to talk to their own tax advisor.

20 Q. And you say on the next paragraph: "Please don't overuse
21 Bob"?

22 A. That's correct.

23 Q. "He's a great resource. And for clients, he specifically
24 asks tax-related questions. He is the go-to person."

25 Is that correct?

1 A. Yes. Yes. That's for our office.

2 Q. That's all I have for 153.

3 Now Mr. Kelley, you heard some testimony about some
4 quarterly account statements that will be sent to customers.
5 Are you familiar with those?

6 A. Yes, I am.

7 Q. And if we could pull up Government Exhibit 155, which has
8 been admitted into evidence. Go up to the first two
9 sections.

10 Looking at Government Exhibit 155, does this look
11 like the kind of quarterly account statement that would be
12 sent to a customer?

13 A. Yes.

14 Q. And were you personally involved in sort of inputting the
15 data into the database that would generate these reports?

16 A. I or my staff, yes.

17 Q. Now, if we could come back out to the main document and
18 go down to the collateral activity details section.

19 So again, Mr. Kelley, you see where it says
20 dividends dollar per share?

21 A. Yes.

22 Q. So this is a Labor Ready stock, 350,000 shares that is
23 used in this particular commerce loan?

24 A. Yes.

25 Q. And when it says that -- well, would you agree with me

1 that, at this moment when the report was sent out, that
2 Derivium did not have 350,000 shares of Labor Ready stock in
3 its physical possession?

4 A. I couldn't say that. I can say that I was not -- I would
5 not have had any access to accounts as to what, you know,
6 whether it was in an account other than what we controlled in
7 our office, and it was not any of those things.

8 Q. Okay. Now, to put together the activity report, or I'm
9 sorry, the quarterly account statements, what kind of
10 research or -- what would you have to do to create those?

11 A. We would go through -- usually, we would use Bloomberg.
12 It's a data provider that you can look up stocks and
13 activities of stocks. And we would look up, you know, a
14 stock such as this. And we would see whether in that, the
15 course of that quarter, whether that stock had paid any
16 dividends or anything that would materially change the
17 client's portfolio.

18 Q. Now, when it says "dividends purchased per share," or
19 "dividends dollar per share," and then, "dividends zero total
20 dollar," how did you know there had been no dividends issued
21 on this particular stock during that quarter?

22 A. We would have looked that stock up for that three-month
23 period.

24 Q. So you had to monitor what was happening to the stock,
25 because again, the company wasn't sending information about

1 the dividends to Derivium; is that correct?

2 A. That's correct.

3 Q. Because the stock had been sold initially; is that
4 correct?

5 A. Well, it was in the possession of the office. That's all
6 we would do. And we were the people that generated the
7 reports.

8 MS. WEIS: Sam, can you back out to the main
9 document?

10 Q. Mr. Kelly, what role did Robert Nagy have in putting
11 together the quarterly account -- quarterly account
12 statements?

13 A. Well, I'm not -- I don't know specifically if he had
14 direct input into the quarterly account statement.

15 I know that I worked very closely with him on the
16 annual statements. As far as the quarterly account
17 statement, you know, from an accounting standpoint, he may or
18 may not have had input, but I don't remember anything
19 specific.

20 Q. So you don't remember if you might have asked him if
21 there should be any items on the report going to customers
22 that would reflect the interest that accrued on a loan?

23 A. Well, the report was already in existence when I was
24 hired.

25 So as far as, you know -- and I know that changed

1 over the years, you know, I worked there. But as far as
2 something specific for the quarterly report, I couldn't -- I
3 couldn't say I remember this specifically from Bob Nagy.

4 Q. Would it help to look at one of your e-mails?

5 A. Yes, it would.

6 MS. WEIS: Your Honor, may I approach the witness?

7 THE COURT: Sure.

8 Q. So Mr. Kelly, if you could read all that through --

9 A. Okay.

10 Q. -- and pay attention to D and C.

11 A. Okay.

12 Q. Let me know when you are finished.

13 A. Okay.

14 THE COURT: Have you got a number on that?

15 MS. WEIS: No, it's just being used to refresh his
16 recollection.

17 THE COURT: Okay.

18 THE WITNESS: Okay.

19 Q. Now, Mr. Kelly, I'm sorry, the Rules require me -- I'm
20 going to come and take that back from you.

21 A. Okay.

22 Q. Mr. Kelly, do you now recall if you ever asked Mr. Nagy
23 if there were -- if he thought that you should include any
24 interest year-to-date item on the quarterly account
25 statements being sent to customers?

1 A. Yes, that -- well, I don't remember that specific e-mail,
2 but it relates to the fact that he brought it out at our
3 annual report.

4 Now, we needed to make some changes to it, and so I
5 asked if that was something that would be appropriate to go
6 into the quarterly report.

7 Q. So you asked Mr. Nagy if that data should go on the
8 quarterly statements that were being sent to customers?

9 A. That's correct.

10 Q. Did you ever ask him if there was anything else that he
11 felt needed to be added to the quarterly client report or
12 anything else that should be reported to the clients in
13 separate reports?

14 A. I would have -- I would have done that at that time
15 because these were difficult reports to change. And if I'm
16 going to make a change, I want to do them all at once. They
17 are complicated.

18 Q. So if he wanted you to make a change, he wanted to know
19 about it then?

20 A. Correct.

21 Q. Mr. Kelly, I would like to ask you -- you said that
22 Derivium provided services to a couple of different of the
23 so-called foreign lenders; is that correct?

24 A. I said that --

25 Q. I'm sorry. I know I talk pretty quick.

1 You said that Derivium provided services to a couple
2 of the so-called foreign lenders; Optech being one of them?

3 A. Yes.

4 Q. Did you provide -- did Derivium provide end-of-month
5 reports to Optech?

6 A. Um, I'm certain we did.

7 Q. Was Mr. Nagy involved in deciding what data was included
8 in those reports to send to foreign lenders?

9 A. He might have something to say. I might ask to talk to
10 each of the Bobs from an accounting standpoint for questions
11 like that.

12 Q. Would it refresh your recollection to take a look at an
13 e-mail of yours?

14 A. Sure. Yes.

15 MS. WEIS: Your Honor, may I approach the witness?

16 Q. So again, Mr. Kelly, take a look through all of that and
17 let me know when you are done.

18 A. Okay.

19 Q. Mr. Kelly, having looked at the document I just handed
20 you, does that refresh your recollection about whether or not
21 you asked Mr. Nagy for input on the type of data that would
22 be sent, end-of-month reports to the so-called foreign
23 lenders?

24 A. Right.

25 I asked both the accountant people -- because again,

1 that was a very complicated report to generate, as well, if I
2 look at that as an accounting report, which I don't know what
3 should go in the report.

4 Q. Do you recall what kind of information was contained in
5 this report?

6 A. It would have been just what we had talked about before.
7 It's a summary of what has been done during the month, both
8 activity wise and a snapshot of, you know, the portfolios at
9 that particular last day of the month usually.

10 Q. And did you ever ask Mr. Nagy if the mock report you sent
11 him met his expectations?

12 A. Um, it's -- yes, I did.

13 Q. Did you ask for his feedback on whether or not the report
14 did, you know, have everything that he wanted?

15 A. I did.

16 Q. And did you send portions of the report to Mr. Nagy that
17 you didn't even send to the so-called lender?

18 A. It looks like I did, yes.

19 MS. WEIS: Your Honor, may I approach the witness?

20 THE COURT: Yeah.

21 MS. WEIS: For the record, I've handed the
22 exhibit -- handed the witness what's been previously marked
23 as Government Exhibit 13. And I only have a clean page of
24 the second page. So page 2, government exhibit.

25 Q. Mr. Kelly, have you had a chance to look at it?

1 A. I'm sorry? I just glanced at it. Is there something
2 specific you want me to look at?

3 Q. Well, is this the type of end-of-month report that
4 Derivium or Veridia would send to Optech?

5 A. Yes, it is.

6 MS. WEIS: Your Honor, at this time we would move to
7 enter -- offer into evidence Government Exhibit 13.

8 MR. COOPER: No objection.

9 THE COURT: In evidence.

10 (Thereupon, Government's Exhibit Number 13 was
11 received in evidence.)

12 MS. WEIS: Can you pull up 13? So if you just blow
13 up, let's say the first, the top, and then the first two
14 boxes.

15 Q. So this is the kind of information that when we were
16 talking about the end-of-month reports, that you consulted
17 with Mr. Nagy about; is that correct?

18 A. Okay.

19 MS. WEIS: Sam, would you turn to the second page and
20 do the same?

21 Q. Mr. Kelly, looking at this, is this the type of
22 end-of-month report --

23 A. Yes, it is.

24 Q. -- you would ask Mr. Nagy's input on?

25 A. Yes.

1 Q. So it has things like the number of loans that are
2 occurring, the amount of the active loans, number of maturing
3 loans and so forth?

4 A. Yes.

5 Q. That's all I have for Government Exhibit 13.

6 A. What's that?

7 Q. That's all I have for Government Exhibit 13.

8 Now, Mr. Kelly, I think you said that, the way you
9 described it, was when you first -- Derivium first received
10 the stock in the brokerage account from the customer, they
11 would sell the stock as the first part of the hedge?

12 A. That's correct.

13 Q. And what was the name of the company that held the
14 brokerage account, or companies?

15 A. Well, it depends on, you know, over time we had -- we
16 worked with a number of different people. So is there a
17 specific time that --

18 Q. Well, let's say when you first started working for FSC,
19 the very beginning, what was the name of the brokerage
20 account or the name of the company that held the brokerage
21 account?

22 A. The name on the account was First Security Capital.

23 Q. And did the name on the account change over time?

24 A. Yes, it did.

25 Q. Do you recall what the next name was?

1 A. Probably the next name was probably Derivium.

2 As we changed, the company changed its name, and
3 then it was somewhere around, I guess 2001, 2002, we were
4 told a lender was willing to disclose its name, and at that
5 point the accounts changed to the lender's name.

6 Q. So for instance, the account was in the name of Bancroft
7 Ventures, Ltd., not Derivium; is that correct?

8 A. Correct.

9 Q. Now, did you work for Bancroft?

10 A. No, I did not.

11 Q. But -- sorry, I didn't mean to cut you off -- but you
12 were authorized to tell the brokerage firm for Bancroft's
13 account to sell stock from Bancroft's account; is that
14 correct?

15 A. Right.

16 Q. How would you have that authority?

17 A. Bancroft authorized it.

18 Q. How do you know that?

19 A. Um, because the -- we had our piece of paper that said
20 Bancroft authorized this, these members of our staff, to work
21 with the -- their brokerage account.

22 Q. Did you ever talk with anyone from the Isle of Man,
23 Bancroft?

24 A. Um, well, I talked to a couple of people over a bit of
25 time, not about that in particular, but you know, about

1 technology issues from the standpoint -- and how we
2 transferred our, you know, the data back and forth, so better
3 from an electronic standpoint, and I'm sure -- and in person,
4 from the standpoint of when we are getting the contracts,
5 we'll be getting information, any information that we might
6 need from them.

7 Q. So you called someone in the Isle of Man and you spoke to
8 them?

9 A. I would call -- they might call me or we might exchange
10 an e-mail.

11 Q. You would talk to someone in the Isle of Man?

12 A. No. I say I don't know, well, I wouldn't know if they
13 were in the Isle of Man or not. It would just be a long
14 distance phone call.

15 Q. And the technology services that you referenced before,
16 was that a person that came into the office?

17 A. A technical person came and talked to us about, you know,
18 tried to make sure that if we were going to transfer our data
19 to them in a timely fashion, you know, he wanted to see how
20 we captured the data.

21 So then I would send the information to him so that
22 we wouldn't have to be faxing things or mailing.

23 Q. This tech person, this was in the United States; is that
24 correct?

25 A. He came to our office, yes.

1 Q. Did he say if he was from the Isle of Man?

2 A. Um, I don't think so. I think he was from London maybe;
3 had a British accent.

4 Q. Now Mr. Kelly, were you able to tell brokerage firms or,
5 you know, Optech being another example, to sell brokerage --
6 to sell stock that was in Optech's brokerage account?

7 A. Yes.

8 MS. WEIS: Your Honor, may I approach the witness?

9 THE COURT: Sure. You have blanket permission to
10 approach the witness unless he says no. How about that?

11 MS. WEIS: Okay. Keep it simple.

12 Q. And for the record, I'm going to be handing you what's
13 been previously marked as Government Exhibit 317. 317.

14 Mr. Kelly, could you take a look at that account or
15 that document?

16 A. Okay.

17 Q. All right. And again, Mr. Kelly, if you look down at the
18 very, very bottom, is that your e-mail address?

19 A. It is.

20 Q. And at the top, the date, were you working at Derivium on
21 April 1, 2004?

22 A. You mean Veridia?

23 Q. Veridia. I'm sorry.

24 A. Yes.

25 MS. WEIS: Your Honor, at this time we would move

1 into evidence Government Exhibit 317.

2 MR. COOPER: No objection.

3 THE COURT: In evidence.

4 MS. WEIS: Sam, could you blow up as of April 1,
5 2004?

6 Q. Mr. Kelly, this is an e-mail that you wrote stating as of
7 April 1, 2004: "We currently have seven accounts, DC USA;
8 DC; LLC; Veridia; Bancroft; Optech; Shenandoah and Spencer."

9 Is that correct?

10 A. That's correct.

11 Q. All right. Now, when you say "seven accounts," what are
12 you referring to?

13 A. Well, this is -- refers to the being able to access bank
14 accounts on line, which at the time required a different
15 level of permissions.

16 In other words, you couldn't, you know, talk to a
17 bank, and this outlined each of the people that was working
18 and what they could do online with these accounts.

19 It has -- you know, we would never send any funds
20 that we didn't have one person initiate; another person would
21 confirm. So you always had two eyes, two sets of eyes, you
22 know, on each one.

23 And since at least one of these accounts, companies
24 is not something I lended with, I would imagine that I was
25 given the information of who to -- who would have access and

1 then I distributed that information.

2 Q. Okay. So when it says "DC USA," do you understand that
3 to be Derivium USA?

4 A. Yes.

5 Q. And when it says "DC LLC," do you understand that to be
6 Derivium Capital LLC?

7 A. I think so. Um, after I started to work for Veridia,
8 Derivium changed, you know, as far as its corporate
9 structure. And whether Derivium Capital is the same as DC
10 LLC, I'm not sure. But certainly DC USA is DC USA as you
11 show there.

12 Q. And then Veridia, is Veridia that you were working for?

13 A. That's who I worked for.

14 Q. Bancroft being the so-called lender you referred to
15 earlier?

16 A. Yes.

17 Q. And I'm just saying "so-called lender" not to confuse
18 you.

19 A. Okay.

20 Q. Optech?

21 A. Is in Hong Kong.

22 Q. Right.

23 Shenandoah, this entity over here?

24 A. Yeah. I actually don't know much about Shenandoah, but
25 Yuri did take ill at one point and they needed someone to be

1 able to transfer, so they asked me to. They added me to that
2 list so that I could confirm.

3 Q. "Yuri," being Yuri Debevc?

4 A. Yuri Debevc. I'm sorry.

5 Q. And then Spencer -- what did you understand about
6 Spencer?

7 A. I'm not very -- I'm not familiar with Spencer, other than
8 I've heard the name.

9 Q. Okay. It lists Ron, Walter, Catherine, Rebecca. Are
10 those four individuals, were they employees in the back
11 office?

12 A. Yes.

13 Q. And Catherine in particular, do you remember what her
14 last name was?

15 A. Sandifer.

16 Q. Was she married to Jonathan Sandifer --

17 A. Yes.

18 Q. -- the gentleman you replaced when you first started with
19 the company?

20 A. Yes, she was.

21 Q. Yuri down below, "Do everything for DC LLC, do everything
22 for DC LLC, Veridia, Bancroft, Optech, Shenandoah," and that
23 is Yuri Debevc?

24 A. My eyes -- I blanked out which person you were following.
25 You were following Catherine?

1 Q. We are following Yuri.

2 A. Okay. I'm sorry. Okay.

3 Q. That's Yuri Debevc?

4 A. That is Yuri Debevc.

5 Q. And then the next line down it says "Pat". Is that you,
6 Patrick Kelly?

7 A. Yes, it is.

8 Q. So you had access for DC LLC, which you think was
9 Derivium Capital, but you are not sure; is that correct?

10 A. That's correct.

11 Q. And then Veridia, Bancroft, Optech -- and then you've
12 already explained Shenandoah.

13 A. Yes.

14 Q. And then down at the very bottom: "Jonathan, do
15 everything for Spencer. Yuri confirms wires."

16 Who is Jonathan?

17 A. That's Jonathan Sandifer, the person I replaced.

18 MS. WEIS: That's all I have for Government
19 Exhibit 317.

20 THE COURT: Okay.

21 Q. And Mr. Kelly, in addition to telling brokerage firms to
22 sell stock from, you know, Bancroft's account, for example,
23 what other services did Veridia provide to Bancroft?

24 A. Actually, what names did you already say?

25 Q. What other services did Derivium provide to Bancroft?

1 A. Besides?

2 Q. Besides, you know, telling brokers to trade securities in
3 their account?

4 A. We would report to them every month. We would -- if a
5 client was a borrower who is going to take out a loan, then
6 we send all the contracts to Bancroft. We notify Bancroft
7 before funds were distributed, the end of the month stuff.

8 Q. Okay.

9 A. I'm sure there is more.

10 Q. If a customer wanted to send Bancroft some mail, were --
11 what -- do you know where that mail would be sent?

12 A. I -- I probably had an address somewhere, but I don't
13 know what the address was.

14 The clients, I believe for the most part, if they
15 wanted to send something to Bancroft if it related to the
16 loan, then they would send it to us because we were their
17 U.S. representative. So if they had a question about their
18 reports, anything like that, we created all of them;
19 therefore, they would ask us.

20 Q. So you could receive mail on Bancroft's behalf?

21 A. Yes, we do.

22 Q. And where was your office? Was it here in Charleston?

23 A. It was here in Charleston, um, 1 Poston Road, which is on
24 Cosgrove, Sam Rittenburg, that area.

25 Q. Now, the mail that was addressed to Bancroft, was that

1 also sent to 1 Poston Road?

2 A. That's what I just said, yes.

3 Q. Did you also receive mail from Optech at that address?

4 A. Yes, we would.

5 Q. Now, what about sending mail on Bancroft letterhead,
6 could you do that?

7 A. If it related to a borrower and their loan, yes.

8 Q. Did Veridia have a manual in place to help its employees
9 out to figure out, you know, in its manual, day-to-day
10 operations; that kind of thing?

11 A. Yes, we did.

12 Q. For the record, I've just handed the witness Government
13 Exhibit 265.

14 Q. Mr. Kelly, would you just take a minute to look through
15 it? It's a big document.

16 A. It's a big document. It makes more sense for where
17 you've got a question.

18 Q. Does it look to be some of the materials that were
19 included in Veridia's operations manual that you were aware
20 of?

21 A. It does.

22 MS. WEIS: We would move into evidence 265.

23 MR. COOPER: 402. 403.

24 THE COURT: Do you want to do it page at a time?
25 Which page are you looking at?

1 MS. WEIS: There will be a couple different ones.

2 THE COURT: Take them out individually.

3 MS. WEIS: Sure.

4 It's going to be -- we have to take it back from
5 him.

6 THE COURT: Okay, or you can use mine.

7 MS. WEIS: That's okay. It's not page numbered.

8 If you just bear with me for a second.

9 Q. Mr. Kelly, could you take a look at what's before you,
10 the first page of Government Exhibit 265, and let me know
11 when you are done?

12 A. Okay.

13 Q. Mr. Kelly, is this the kind of document that you would
14 send customers on Bancroft letterhead, as far as your work
15 with Derivium?

16 A. Yes, it is.

17 MR. COOPER: Your Honor, I couldn't hear the page
18 number.

19 MS. WEIS: Page 41. At this time we would move into
20 evidence what we'll mark as Government Exhibit 352.

21 MR. COOPER: I can't find what she's talking about.

22 THE COURT: Okay. She'll show it to you.

23 MR. COOPER: Again, 402. 403.

24 THE COURT: Overruled.

25 (Thereupon, Government's Exhibit Number 352 was

1 received in evidence.)

2 MS. WEIS: At this time, we would move into evidence
3 Government Exhibit 352.

4 THE COURT: Okay.

5 MS. WEIS: Could you pull up 265041? And can you
6 blow up the top half of that document?

7 Q. So Mr. Kelly, could you explain what "delivery of loan
8 proceeds instructions" are to the jury?

9 A. Yes. If a borrower, you know, submitted a portfolio to
10 us and when we funded their loan, we would have to have
11 something in writing from them with their signature stating
12 exactly where they wanted the funds transferred.

13 Q. And it says: "Please submit completed form to Bancroft
14 loan processing via fax and submit the original via mail" --
15 the last sentence of that first paragraph -- and it says --
16 "via mail/overnight, attention Patrick Kelly."

17 That's yourself; is that correct?

18 A. That's correct.

19 Q. And then there is an address there that says: "Loan
20 processing representative, Bancroft loan processing, 1 Poston
21 Road, Suite 120, Charleston, South Carolina."

22 So is that the address you were referring to
23 earlier --

24 A. That's correct.

25 Q. -- all that half?

1 MS. WEIS: And that's all I have for Government
2 Exhibit 352.

3 Q. Now, Mr. Kelly, how about if a customer wanted to call
4 and had a question about a loan that was through, you know,
5 if it was papered as being Bancroft, is there someone in the
6 United States that they can call?

7 A. Depending on what the question was, they would probably
8 call our office.

9 Q. Now, what they call Veridia or what they call the
10 Bancroft U.S. Processing Office?

11 A. We had several lenders that we worked with.

12 Consequently, if a client, you know, was calling our
13 office, we were authorized to talk to them about any of the
14 lenders that we worked with directly there at Veridia.

15 So yes, if a Bancroft client called and would call
16 and ask us -- because we handled all of the, you know, back
17 office operations for Bancroft here in the United States for
18 their loans.

19 Q. Would you identify yourselves as working for Veridia or
20 for Bancroft?

21 A. It's -- usually if it was -- if they called on a Bancroft
22 phone line, then we would answer it as Bancroft, but --
23 because, you know, the client -- many of the clients had
24 called in before when they just talked to Veridia. So, you
25 know, you might --

1 Q. So there was different phone lines that came into your
2 office; one designated for Bancroft and one designated for
3 Veridia?

4 A. Correct. So you know, when you answer the phone, you
5 wouldn't confuse the client.

6 Q. What about WITCO? Was there a line that came into
7 Veridia's office for WITCO?

8 A. I don't think so. If there was, I don't remember, um,
9 that, because we maintained their database, but -- and I
10 could be mistaken, but it seems that WITCO was an offshore
11 entity that we were just handling back office operations for.

12 I don't -- I don't remember if they had a
13 representative in our office. I don't think I ever was one.

14 Q. Would it refresh your recollection to look at any --

15 A. Yes, it would.

16 Q. -- to the document?

17 MS. WEIS: For the record, I've handed, for purposes
18 of refreshment, Government Exhibit 238.

19 Q. And Mr. Kelly, if you could look at item 7 and let me
20 know when you are done.

21 A. Okay.

22 Q. Are you done?

23 A. Yes.

24 Q. Mr. Kelly, is your memory refreshed as to whether or not
25 Derivium could answer phone lines for WITCO?

1 A. Yes, we did.

2 Q. What about Optech? Would you answer phones for Optech?

3 A. We would.

4 Q. Now, as I understand it -- well, was there a time in
5 which customers were not told the name of the particular
6 so-called lender?

7 A. Yes.

8 Q. And do you remember when the transition occurred when
9 customers were told of the name of the so-called lender?

10 A. Not exactly. I think it was around 2000, 2001, something
11 in there, but I might have, you know, some documents that,
12 you know, would tell me. It seems like it was the first of
13 the year for -- but I could be mistaken.

14 Q. And from the back office perspective, did you get
15 questions from customers about why they were being, you know,
16 given the name of the lender now?

17 A. Yes.

18 Q. In particular for Bancroft, do you recall customers
19 calling with questions about who is Bancroft and that sort of
20 thing?

21 A. Well, we had always received questions about who the
22 lender was, and we had been directed that the lender was not
23 wanting to disclose who they were, as they do not want people
24 contacting them directly. And then to the point where
25 Bancroft, you know, made us official representative, we list

1 their name and they had -- list the website information and
2 who they were.

3 And at that point, yes, and you know -- so some
4 clients had been expecting it and some clients didn't know
5 who the lender had been and never asked.

6 Q. Now, you keep saying you know Bancroft wanted these
7 things. Who communicated this to you?

8 A. Dr. Cathcart.

9 Q. So it was Dr. Cathcart that was the one telling you about
10 what Bancroft supposedly wanted; is that correct?

11 A. Either Dr. Cathcart or Scott Cathcart. Scott was the
12 head of marketing and, you know, that was a challenge for
13 them to transition, so it would come from either of them.

14 Q. So you weren't personally involved in any -- any
15 negotiations or anything that would have occurred between
16 Derivium and Bancroft, for example?

17 A. No.

18 Q. And any conversations about whether or not they were the
19 lender, so-called lender --

20 A. No.

21 Q. -- or who they were in the first place; is that correct?

22 A. We were just told that they are the lender and unwilling
23 to disclose who they were, and now they were willing to
24 disclose that.

25 Q. And that was told to you by Charles Cathcart or Scott --

1 A. Right.

2 Q. -- his son?

3 A. Correct.

4 Q. Mr. Kelly, I'm going to hand you what's been previously
5 marked as Government Exhibit 182.

6 Again, just let me know when you've had a minute to
7 look at it.

8 A. Okay.

9 Q. Mr. Kelly, if you look at the last page again, is that
10 your e-mail address at the very bottom?

11 A. It is.

12 Q. And if you look at the first page, in the middle of the
13 page with the date, is that a date you were employed by
14 Derivium or Veridia?

15 A. I think the change actually happened the first of
16 January.

17 Q. Okay. So --

18 A. I should probably have had Veridia e-mail.

19 Q. But you were with one of the two companies at that point?

20 A. Well, based on what the e-mail says, um, probably at that
21 point I was probably a Veridia employee, and still using the
22 e-mail that I had always used.

23 Q. Okay. And when you look at this e-mail, does this
24 accurately reflect what you recall about answering questions
25 for customers about the revelation of BVL's name as a lender?

1 A. Yes.

2 MS. WEIS: Your Honor, at this time we would move to
3 offer into evidence Government Exhibit 182.

4 MR. COOPER: No objection.

5 THE COURT: In evidence.

6 (Thereupon, Government's Exhibit Number 182 was
7 received in evidence.)

8 Q. And Sam, if you could look at the second e-mail down
9 below on the first page, the bottom.

10 So Mr. Kelly, this is an e-mail from you to Charles
11 Cathcart, C. Hsin, Catherine Sandifer and Yuri Debevc.
12 "Subject: BVL script for staff."

13 Is that correct?

14 A. Say that last part again.

15 Q. "BVL script for staff."

16 Is that correct?

17 A. Yes.

18 Q. And you say: "Charles, Catherine and I created a rough
19 draft of how Lynn will answer the phone and direct the caller
20 to BVL and how additional questions might be answered if
21 needed."

22 So my first question is: Do you recall who Lynn is?

23 A. Lynn worked in the second building that we had, but she
24 worked in our separate office and she was in marketing.

25 Q. So she worked for Derivium USA after the split?

1 A. Well, I think so. I'm a little confused about which
2 company was which, but that sounds right, she did not work
3 for Veridia.

4 Q. And if you look down, there is sort of a, you know,
5 dialogue. And it says: "DC USA, Derivium Capital, how may I
6 help you?" Caller identifies himself. And then DC USA says,
7 "Bancroft Ventures, Ltd., your lender of record, is now
8 handling these questions directly. I can transfer you to an
9 agent of BVL now and for future reference they may be reached
10 directly at 843-725-1130."

11 843. That's a Charleston area code?

12 A. Correct.

13 Q. And is that the -- you know, you may not remember the
14 exact number -- but those were the phone lines that you were
15 referring to before where Veridia employees could answer for
16 Bancroft if need be?

17 A. Correct.

18 MS. WEIS: Now, would you turn to the second page.
19 Just blow up -- actually, that's good.

20 Q. Look at question 5 at the end.

21 So now Mr. Kelly, these are questions that you were
22 anticipating, or you, Ms. Sandifer and Mr. Cathcart were
23 anticipating from customers?

24 A. Well, actually it's sent to Charles, and it's --
25 Catherine and I created this language to see if he likes it.

1 Q. Okay. All right. So --

2 A. I mean, I could be mistaken, but that's what I thought I
3 was saying here.

4 Q. Okay. So question 5 is one of those questions that you
5 sort of, you know, anticipated that might need to be
6 addressed; is that correct?

7 A. Yes.

8 Q. And that question is the client asking: "I've talked
9 with a BVL office. Why am I still working for the same
10 people that used to work for Derivium in the processing
11 office."

12 Is that correct?

13 A. Yes.

14 MS. WEIS: That's all the questions I have for
15 Government Exhibit 182.

16 Q. Now, Mr. Kelly, at the end of the 90% Loan Transaction,
17 when that transaction came to maturity, what options did the
18 customer have at that point?

19 A. Um, without looking at our sheet -- basically, if their
20 collateral value was worth less than their loan payoff, then
21 they could return -- just walk away. In other words, they
22 didn't have to do anything. They could notify us that they
23 did not want to renew the loan and that was the end of the
24 relationship.

25 The -- they could have -- um, if the collateral was

1 worth less than the loan payoff but they wanted to renew the
2 loan, then depending on what year this was, the terms changed
3 over time, but they could transition where they could pay a
4 fee.

5 And I have forgotten however it was technically
6 termed, but basically, you know, their collateral was worth
7 less than their loan payoff, but they would pay a fee and
8 they would renew the loan for a set period of time, say,
9 another three years.

10 If the loan was -- the collateral was worth more
11 than the loan payoff, then they could renew the loan and
12 receive funds, you know, for -- relating to the difference in
13 the value. They could pay the loan off and receive a
14 collateral back. And it seems like there was a 51, and I
15 can't remember, but maybe I miscounted.

16 Q. Now, when a customer wanted to renew the loan, and I'll
17 refer to renew regardless of the value of the collateral --

18 A. Okay.

19 Q. -- whether it was above the so-called collateral, whether
20 it was above or below the loan amount at maturity, from a
21 back office perspective, what did you need to do if a
22 customer said, I want to sign on for another three years?

23 A. We would contact the marketing department and they would
24 start working with the client to generate the contracts for
25 them.

1 Q. So there would be a new, you know, so-called loan
2 agreement, for example, that the customer would have to sign?

3 A. Um, yes.

4 I -- and again, it comes back to, you know, depends
5 on whether if they had maybe already signed, it was basically
6 a loan, single-page document, and then there is sort of an
7 umbrella document.

8 If they had signed the most recent of these umbrella
9 documents, then they would just have the single page to renew
10 that loan. If they had an old document, then we would have
11 to update the paperwork to the most current paperwork.

12 Q. Now, when they signed this new paperwork, would you use
13 the same -- exact same loan number that you had used
14 originally?

15 A. No.

16 Q. You would assign a new loan number to it?

17 A. Correct.

18 Q. And that loan number had an R in it?

19 A. Certainly. I think that all of them did. You know, we
20 worked our way through some teething problems in how to do it
21 so we couldn't get confused, and it's entirely possible that
22 the first couple that we did, we did put an R until we
23 realized that that was a mistake, but -- we got confused with
24 the client, but for the most part, yes.

25 Q. Now, some customers, they elected to, instead of renewing

1 the loan, to pay off a loan to get the stock back; is that
2 correct?

3 A. That's correct.

4 Q. And are you aware of any problems that customers might
5 have encountered at that point?

6 A. Some customers had problems; some customers did not.

7 Q. Now, for the customers that had problems, were you given
8 any special instructions for the back office on how to handle
9 those customers?

10 A. Well, we had -- a few customers had problems and we were
11 given explanations for why, you know, they were having
12 problems, or at least a brief snapshot of it, and if that
13 client called, then they needed to talk to Dr. Cathcart;
14 possibly Yuri. Though if Dr. Cathcart was available, I know
15 calls all went to him, and I don't know what was discussed.

16 Q. Okay. So if a customer, one of the customers identified
17 as having a problem called, who was it that instructed you to
18 pass them on to Mr. Cathcart or Mr. Debevc?

19 A. Well, probably the initial person is Dr. Cathcart, but in
20 a small office, you know, you might be reminded of this, um,
21 you know, by Mr. Debevc, but I'm reasonably certain that it
22 probably came from Dr. Cathcart.

23 Q. Okay. Now, just a couple last questions for you.

24 If we could back up a couple stages in the
25 transaction. When Derivium received the customer stock or

1 the stock was received into the lender's account after the
2 change, when you would call the brokerage account, would you
3 call the brokerage account to tell them what to do with the
4 stock? How would you communicate with them?

5 A. Um, we could do faxes, we would do phone, um, we had,
6 depending on what was being communicated, certain things, you
7 know, had to be done by forms, by paperwork, rather than, you
8 know, just a phone call. You know, they would not accept,
9 say, a client's portfolio into the account without something
10 signed, you know, so that, you know, there would be no
11 confusion over phone calls to a client to transfer something.

12 Q. And I should have clarified, when we were talking about
13 problems with customers you would encounter, those problems
14 were that Derivium, they were asking for their stock back and
15 they weren't getting the stock back; is that correct?

16 A. I don't know that it was all that they were asking for
17 was their stock back, um, there -- it was explained that, you
18 know -- I remember one client had a problem with their
19 contracts; another client, it's entirely possible that maybe
20 they should not -- the SEC wouldn't come out to do the
21 original transaction.

22 Q. But the problem that had -- those were things that were
23 communicated to you by Mr. Cathcart; is that correct?

24 A. Well, for -- you know, as I said, for these few clients,
25 there was -- and I don't remember what the number -- it's

1 like four or five specific clients, they, you know -- there
2 was a problem with, you know, their loan at maturity, and
3 they were going to have to owe Dr. Cathcart, whether they
4 were going to lawyers beyond that --

5 Q. Yeah, I'm not --

6 A. -- dealing with lawyers.

7 Q. So when I say the problem the customer encountered, I
8 guess I'm not asking for what the explanation was that was
9 provided for why, you know, from Derivium's perspective there
10 was a problem, but that specific thing that the customer was
11 requesting was their stock back; is that correct?

12 A. I don't know that for certain. I mean, they might have
13 been wanting to renew the loan.

14 Q. Okay. Now -- I'm sorry.

15 A. Either way they could not do it. They couldn't do
16 something they wanted to do.

17 Q. Okay. So we were talking about when you communicated
18 with brokerage accounts, the brokerage firms, the brokers,
19 and if you needed at the beginning of a transaction to have,
20 as you called it, the first step of the hedge to sell the
21 stock, what language would you use? What wording would you
22 use to communicate that to the broker?

23 A. Well, we would tell them we -- when you work with a
24 broker, you've got a very specific set of words and languages
25 and you have to say it in the right order. Because when you

1 are handling a large transaction -- you know, if you say the
2 words even out of order, they may stop and they say -- you
3 know, you are communicating by phone, you've got to say it in
4 this record, you have to -- you know, the stock has to come
5 to a certain place, the quantity, the selling price, so you
6 had a specific language.

7 So we would tell them, you know, in essence, you
8 know, that we had to sell a certain quantity of this at this
9 price.

10 Q. So you would use the word "sell"; not "cash"?

11 A. Definitely. No. With the brokerage firm there is only
12 one word.

13 Q. Okay. And when you communicated with customers, were you
14 allowed to say that, we sold your stock?

15 A. No. We would tell them that the hedging process started
16 in our office.

17 Q. So you weren't allowed to say "sell," you had to say
18 "hedge"?

19 A. Because that, as explained to us, that was the start of
20 the hedging process.

21 Q. That was explained to you by Dr. Cathcart?

22 A. Um, and Yuri.

23 Q. And Yuri Dubevc?

24 A. Um-hum.

25 Q. Now, Mr. Kelly, as part of your work at Derivium, did you

1 sign a confidentiality agreement that prohibited you from
2 talking about, you know, what you were doing in the back
3 office?

4 A. About anything, yes.

5 Q. So anything, including that you were selling stock, that
6 wasn't something you were allowed to disclose?

7 A. Right. You know, sort of like a nondisclosure, we
8 don't -- you know, we don't talk about this company with
9 anybody until, you know, a certain period of time after we
10 were gone.

11 Q. But you were allowed to talk with Mr. Nagy about that; is
12 that correct?

13 A. That's correct.

14 MS. WEIS: No other questions at this time.

15 CROSS-EXAMINATION

16 BY MR. COOPER:

17 Q. Hello, Mr. Kelly.

18 Now, just starting where we left off there at the
19 end, it was Dr. Cathcart and Yuri who told you to tell
20 clients the stock was hedged, correct?

21 A. That is correct.

22 Q. Mr. Nagy didn't tell you that?

23 A. No.

24 Q. He wasn't your boss?

25 A. No.

1 Q. And you also said there was several lenders, correct?

2 A. Yes.

3 Q. Did you believe they were real lenders?

4 MS. WEIS: Objection, relevance.

5 THE COURT: Overruled.

6 Q. What is your answer?

7 A. Yes.

8 Q. Did you -- when did you start working there again?

9 A. Um, I think it was 1999. It could have been '98, but I'm
10 pretty sure 1999.

11 Q. So '99 to 2006; is that correct?

12 A. Yes.

13 Q. And then Derivium filed bankruptcy in April of '05, I
14 believe?

15 A. Um, I don't know. I'll take your word for it.

16 Q. Okay. So let's just say from '99 to 2005, from being an
17 employee for that extent of time, did you believe that all of
18 these lenders were real?

19 A. Yes.

20 Q. And you wouldn't have been engaged in this if you thought
21 they were fictitious lenders over there, right?

22 A. Well, no. I mean, that's -- we thought that we had, you
23 know, we were working for a legitimate company.

24 Q. And then she asked you some questions about these phone
25 lines?

1 A. Yes.

2 Q. Did Mr. Nagy answer phones at Derivium?

3 A. No.

4 Q. Did Mr. Nagy set up that, those phone lines?

5 A. No.

6 Q. Did Mr. Nagy tell you how to answer the phone?

7 A. No.

8 Q. Let me ask you this: Have you ever called customer
9 support?

10 A. Sure.

11 As a matter of fact, that's what we were. That was
12 how it was explained to us was, you know, we are like a
13 customer support office, the back office, that worked with
14 multiple lenders; and therefore, we answered based on who the
15 client was.

16 Q. Well, my question is this: Did you ever call customer
17 support about somebody in India?

18 A. Yes.

19 Q. Did that mean to you that something bad was going on?

20 A. No, other than if I couldn't understand sometimes.

21 Q. They do speak English, though?

22 A. Right. Some.

23 THE COURT: No, they speak the King's English. We
24 speak our own.

25 MR. COOPER: That's right. We speak southern.

1 THE WITNESS: Yes.

2 Q. Dr. Cathcart, you worked for him the whole time you were
3 there, right?

4 A. Well, I didn't work for Dr. Cathcart specifically once it
5 became Veridia. As explained to me, Yuri was the owner of
6 Veridia and I worked for Yuri.

7 Q. But were you familiar with Dr. Cathcart? You said it was
8 a small office?

9 A. Oh, it was a small office, and we still, per Yuri, we
10 took direction from Dr. Cathcart because at that point
11 Derivium was one of our clients.

12 Q. What's your owner's standing as to Dr. Cathcart's
13 background in economics?

14 A. He had a Ph.D. in economics, taught some at the College
15 of Charleston. He had worked at Citibank. He had awards on
16 his shelf from, you know, starting new types of transactions
17 that had never been done before from, you know, here in the
18 U.S. and --

19 Q. So he was -- he was considered pretty ingenuous in
20 financial products?

21 MS. WEIS: Objection, foundation.

22 Q. Was it your understanding that he was ingenuous with
23 financial products?

24 A. That is --

25 MS. WEIS: Objection, relevance.

1 THE COURT: Go ahead and restate the question. I
2 didn't understand the question.

3 MR. COOPER: Okay.

4 Q. From your interaction with Dr. Cathcart and what you saw,
5 was it your belief that he had a deep background in financial
6 products?

7 A. Yes.

8 MS. WEIS: Objection, 402.

9 THE COURT: Overruled.

10 Q. And what was your understanding that actually Dr.
11 Cathcart worked with the CIA?

12 MS. WEIS: Objection.

13 THE COURT: Sustained.

14 Q. Well, was Dr. Cathcart open with his communicating his
15 hedging strategy?

16 A. No.

17 Q. And you were in the office, within that small office with
18 him for about six years?

19 A. Well, he was not there all the time, but he was, you
20 know -- but over -- yes, he was there a lot during that six
21 years.

22 Q. And during that six-year period, you never heard him
23 explain the hedging strategy to anyone?

24 A. Well, at my interview when they hired me, you know, that
25 was when I asked about that. I was told at that point that

1 that was not something that he disclosed, and he never did
2 for the rest of the time.

3 But after that, he was quite specific about that and
4 there was no point in asking after that.

5 Q. What understanding did you have as to what the hedging
6 strategy was?

7 A. Um, we just -- for our office, we were told that we
8 started the process, the hedging process by, you know,
9 selling stock, establishing the value, so that the client
10 knew how much their loan would be. And after that, it was
11 out of our hands. We were not --

12 A. So Dr. Cathcart, the expert in economics --

13 MS. WEIS: Objection.

14 Q. -- explained -- Dr. Cathcart, who had a Ph.D. in
15 economics, explained to you that the sale of the stock was a
16 hedge?

17 A. That's correct.

18 Well, he said it was the start of the hedging
19 process, is the way he phrased it.

20 Q. There was an inference there was something more?

21 A. That's correct.

22 Q. And we know ultimately -- do you have an understanding
23 that part of the hedge was the Summerville and Orangeburg
24 companies?

25 MS. WEIS: Objection. He's already stated --

1 THE COURT: I'll sustain that.

2 Q. Did you ever come to understand that there were no
3 hedges?

4 MS. WEIS: Objection, 602.

5 THE COURT: Overruled.

6 THE WITNESS: Um, no, I -- you know, I can speak to
7 things that I know now, right? As opposed to what I knew
8 then, you know, as far as what I learned after the fact?

9 THE COURT: Make that two questions then.

10 MR. COOPER: Okay.

11 THE WITNESS: Okay.

12 Q. When did you first understand that there were no hedges?

13 A. After, you know, when the court cases started, and at the
14 point when I was named in one of the suits by loan borrowers.

15 And at that point I was sent a lot of information, I
16 guess, depositions, you know, things that were said. And at
17 that point they stated that the money that, you know, beyond
18 the part that was returned to the client, that ten percent,
19 part of that was put into these entities in Orangeburg, and
20 is --

21 Q. Let me ask you --

22 A. -- that that was supposed to somehow pay for anybody's
23 stock that went up.

24 Q. And you became aware of that after you stopped working
25 for Veridia?

1 A. That's correct.

2 Q. So that would have been post-2006?

3 A. That's correct.

4 Q. So prior to 2006, you didn't know anything?

5 A. We started the hedging process in our office.

6 Q. Were you ever privy to a conversation in a room with Mr.
7 Nagy where he was told --

8 MS. WEIS: Objection.

9 THE COURT: What's the basis of that objection?

10 MS. WEIS: 802.

11 THE COURT: Let him finish the question, and let's
12 see what the answer is, and we'll go from there.

13 MS. WEIS: Your Honor, my concern is with the
14 question itself, with the subject in the question.

15 THE COURT: Go ahead. Ask the question again.

16 Q. Mr. Kelly, were you ever sitting in a room with Mr. Nagy
17 where he was told that there weren't any hedges?

18 A. No.

19 Q. Now, Mr. Nagy was not an employee of Derivium, correct?

20 A. That's my understanding.

21 Q. And you also said that you didn't interact with him
22 often, correct?

23 A. I -- yeah. Depends, I guess. Certainly not weekly, and
24 not even necessarily monthly, but, you know, enough that we
25 knew each other very well.

1 Q. When need be?

2 A. Correct.

3 Q. He was an outside resource?

4 A. Correct.

5 Q. Now, she kept on talking about these reports that Mr.
6 Nagy and Mr. Brandenburg asked for.

7 Do you recall that questioning?

8 A. I do.

9 Q. Okay. I want to clarify what those reports are.

10 Were those reports that you generated in order to
11 help Mr. Brandenburg and Mr. Nagy understand the income that
12 they should report?

13 A. Yes. Well, not just the income, but everything that our
14 operations office did, which meant that, you know, it would
15 be, you know, portfolios submitted to us, you know, income
16 generated, um, and snapshots of what -- the portfolios, the
17 loans, all of this, you know -- what that snapshot at the end
18 of the month, what I think was accounting information, so
19 that someone can generate an accounting report of our
20 company's -- our office's business.

21 Q. Right.

22 And was your understanding that that information was
23 needed in order to do the quarterly financial reporting?

24 A. That's what I assumed, it was all accounting related from
25 the standpoint of discussions about how to properly report

1 things.

2 Q. Okay. So the reports weren't related to how well the
3 loan portfolio was doing?

4 A. That would -- it depends on, you know, I guess you have
5 to define how well.

6 Q. I want to show you what's marked as Government's
7 Exhibit 172.

8 THE COURT: Government's Exhibit 172?

9 MR. COOPER: Yes, Your Honor.

10 THE COURT: Okay.

11 Q. And do you recognize that report?

12 A. Yes.

13 Q. And when I refer to a report about how well the loan
14 portfolio is doing, does that help you recall what report
15 that is?

16 A. Yes.

17 Q. Was that a report that you produced as an employee of
18 Veridia?

19 A. Yes.

20 THE COURT: I guess it's in evidence, right?

21 THE CLERK: No, sir.

22 MR. COOPER: I move it into evidence.

23 THE COURT: Do you have any objection to your own
24 exhibit?

25 MS. WEIS: No, Your Honor.

1 THE COURT: Okay. Got it.

2 MR. COOPER: Thank you.

3 (Thereupon, Government's Exhibit Number 172 was
4 received in evidence.)

5 Q. These are called the "In The Money loan reports,"
6 correct?

7 A. That's correct.

8 Q. And it showed the loan portfolio, correct?

9 A. That's correct.

10 Q. And this document was a document that was distributed to
11 Charles and Scott Cathcart to let them know how things were
12 going, correct?

13 A. That's correct.

14 Q. This was not a report that was circulated to Mr. Nagy?

15 A. I do not know. If I had, um, I would be given a -- we
16 had sort of a standard list of who it was distributed to. I
17 was given, you know, these names and I just put it in my
18 e-mail program, and we put those reports together, I clicked
19 on that group. And at the moment, I don't remember who was
20 in the group.

21 Q. And do you recall specifically distributing this to Mr.
22 Nagy?

23 A. I don't recall.

24 Q. And then internally at Derivium, Bob Brandenburg was a
25 CPA, right?

1 A. That's correct.

2 Q. And there were bookkeepers? Debbie Young?

3 A. Yes.

4 Q. Ms. Hoff, was she a bookkeeper?

5 A. Could very well be, yeah.

6 Q. Catherine Sandifer?

7 A. Yes, we had -- we had several people that filled that
8 position. Some didn't stay as long as others stayed.

9 Q. Did Bob Brandenburg ever communicate to you that --

10 MS. WEIS: Objection, hearsay.

11 THE COURT: Sustained.

12 Q. From being in a small -- understanding -- I mean, in a
13 small office, did you ever come to the understanding that
14 anything wrong was going on?

15 A. Not until after the fact, but -- not while we were
16 working there.

17 And I guess I'll clarify that. You know, some of
18 the things, you know -- as far as when you say "wrong," um,
19 some of the things that, you know, I understood that they
20 could charge with seems to be open to interpretation. So I'm
21 not sure I --

22 MS. WEIS: Objection, Your Honor.

23 THE COURT: Overruled.

24 MS. WEIS: Can we get a clarification? When he says
25 "charge," there is no criminal matter.

1 THE COURT: No criminal matter.

2 THE WITNESS: Oh, okay.

3 Q. I'm going to show you our Exhibit Number 36.

4 And you talked to Ms. Weis about the year-end
5 statements?

6 A. Yes.

7 Q. Is that one of the year-end statements?

8 A. I -- yes.

9 Q. Well actually, it's several year-end statements, isn't
10 it?

11 A. Right. It is.

12 Q. And who were those statements for?

13 A. Um, do you want me to just work from the top one?

14 Q. No. To whom were the statements sent?

15 A. All of them?

16 Q. Yes, sir.

17 A. Um, went to Scott and Cathcart.

18 Q. And were those documents produced by Derivium?

19 A. Yes.

20 Q. And would those have been the year-end reports that you
21 spoke about that y'all generated?

22 A. Yes.

23 MR. COOPER: If I can move Exhibit 36 in, please,
24 Your Honor.

25 THE COURT: Any objection?

1 MS. WEIS: I'm not quite sure whose Exhibit 36 it
2 is.

3 MR. COOPER: It's ours.

4 THE COURT: It's Government's Exhibit 36?

5 MR. COOPER: No, this is mine.

6 THE COURT: Okay. Show it to her.

7 MS. WEIS: Your Honor, we have an 801 objection to
8 Mr. Nagy offering these exhibits.

9 THE COURT: Let me see it.

10 Lay a foundation for it and go from there.

11 MR. COOPER: May I hand the document to the witness?

12 THE COURT: Sure.

13 Q. Mr. Kelly, would this have been a document that was
14 produced from Derivium's files?

15 A. Yes.

16 Q. And would this have been a document that was produced by
17 the database that you ran?

18 A. Yes.

19 Q. And do you recognize this document?

20 A. We produced a lot of them. It looks just like, you know,
21 the hundreds of documents that we would produce.

22 So I would say that it's genuine, yes.

23 Q. And would this have been a document that was produced in
24 the ordinary course of Derivium's business?

25 A. Yes.

1 MR. COOPER: Your Honor?

2 THE COURT: Okay. Any objection?

3 MS. WEIS: Your Honor, we still have an 801
4 objection.

5 THE COURT: I think under 803(6) it's a business
6 record, isn't it? He just laid out a whole foundation for
7 that.

8 So assuming it's an 801 objection, I'll overrule it.
9 Go ahead.

10 Q. This is the year-end statement that you said Mr. Nagy
11 assisted you with, correct?

12 A. That's correct.

13 Q. And specifically, he says that -- he gave you advice on
14 correctly reporting the interest expense, correct?

15 A. That's correct.

16 Q. And was your understanding the interest expense needed to
17 be there so the borrowers could --

18 MS. WEIS: Objection.

19 THE COURT: Sustained. I assume that's an 801 and
20 I'll sustain that.

21 Q. And there is also on the document dividends, correct?

22 A. Yes.

23 Q. And is that something Mr. Nagy wanted, that reported on
24 the report?

25 A. Yes.

1 Q. And the interest, was that something that Mr. Nagy wanted
2 on the report?

3 A. Yes.

4 Q. And was your understanding that that information was so
5 people could correctly report their taxes?

6 A. Yes.

7 Q. So Mr. Nagy was helping Derivium help its clients comply
8 with the tax laws?

9 MS. WEIS: Objection.

10 THE COURT: Sustained.

11 Q. Was your understanding that this was supposed to help?

12 THE COURT: Sustained.

13 Q. Exhibit 313 --

14 MS. WEIS: Objection, Your Honor, I don't think this
15 is in evidence.

16 MR. COOPER: I thought she put this one in.

17 THE COURT: Government's 313?

18 MR. COOPER: Yes, Your Honor.

19 THE COURT: Okay.

20 THE CLERK: It's not in evidence.

21 THE COURT: I didn't think so. Okay.

22 You can show it to her, it's her exhibit, she may
23 not --

24 Q. I'll show you what's Government 123. Is that your
25 signature at the bottom?

1 A. Yes, it is.

2 Q. Was this a document you sent as an employee of Derivium?

3 A. Yes, it was.

4 MR. COOPER: May I move this into evidence, please?

5 MS. WEIS: 123 or 313?

6 THE COURT: The Government's or yours?

7 MR. COOPER: I'm sorry. The Government's exhibit.

8 MS. WEIS: No objection.

9 THE COURT: Okay.

10 (Thereupon, Government's Exhibit Number 123 was
11 received in evidence.)

12 Q. This is a Derivium letter, correct?

13 A. That's correct.

14 Q. And it's signed by you?

15 A. It is.

16 Q. Is there anything in that letter about tax advice?

17 A. About what?

18 Q. Tax advice.

19 A. No.

20 Q. Did Mr. Nagy cause you to send this letter out?

21 A. No.

22 Q. Exhibit 339 where you were seeking advice --

23 THE COURT: I assume that's Government's Exhibit 339
24 and it's already in evidence?

25 MR. COOPER: Yes, Your Honor.

1 MS. WEIS: Yes, Your Honor.

2 THE COURT: Okay. I just wanted to make sure.

3 Q. Mr. Kelly, did you seek this advice so you could properly
4 account for Derivium's books and records?

5 A. Yes. In other words, I -- are you asking if this is
6 related to an accounting posting, making sure what accounts
7 the expenses, you know, for the technology went into?

8 Q. Right.

9 A. Yes.

10 Q. Is there anything when you wrote this that you thought
11 was untoward about the advice you were seeking?

12 A. I don't -- I just knew that -- no, we were going to use
13 it and therefore we should be -- my position is why should we
14 be paying for those? But I didn't want us to pay for all of
15 it.

16 Q. So you were trying to do things right?

17 A. Yes. But I just thought it was better to ask an
18 accountant than guess.

19 Q. I'll show you what's Exhibit 235.

20 These were the renewal notices that y'all sent.

21 A. Oh, okay.

22 Q. Is there any tax advice in the renewal notices?

23 A. I would doubt it. Um, I have to read the document to
24 see. But, you know, I don't recall that there would be any
25 tax advice in there.

1 Q. Did Mr. Nagy cause y'all to send these to borrowers?

2 A. No.

3 Q. Exhibit 236, the valuation confirmation reports. Is
4 there any tax advice in these reports?

5 A. No.

6 Q. Did Mr. Nagy cause you to send these to borrowers?

7 A. No.

8 Q. The activity confirmation report, is there any tax advice
9 in this?

10 A. No.

11 Q. Did Mr. Nagy cause you to send this to borrowers?

12 A. No.

13 Q. Mr. Kelly, was it your understanding that Derivium did
14 not provide tax advice?

15 A. That's correct.

16 Q. And in fact, weren't there disclaimers on the promotional
17 materials that you didn't provide tax advice?

18 A. That's correct.

19 Q. Weren't there disclaimers on the website that you didn't
20 provide tax advice?

21 A. We were pretty adamant that we didn't even come across
22 as, you know, talking about, you know, the tax implications.

23 Because as explained to us, every client was
24 different and we couldn't give one answer to one client and
25 one answer to another. And we weren't accountants, so

1 they -- um, everything that we were always told in most of
2 the literature was -- is tell the client to first talk to,
3 you know, their own tax advisor, and/or in this case, you
4 know, if they had -- this related to the year-end statement
5 and we were sending out that information so at least -- I
6 think that's what this one is.

7 Q. And, in fact, it was your understanding that Mr. Nagy
8 wouldn't provide tax advice to either the client's advisors
9 or the borrowers?

10 A. Well, let's say his client -- in other words, from the
11 standpoint if someone -- if we -- someone called and asked us
12 a tax question and we thought that it was something related
13 to, you know, the research we had done, we could, you know,
14 have them talk to Bob.

15 But, you know, unless he took them on as a client or
16 something, you know, he didn't have any relationship with the
17 people that would call our office. He was a resource.

18 Q. Right.

19 And when you say "borrowers," how many borrowers did
20 these transactions -- was it in excess of 1300?

21 A. Um, I couldn't -- I mean, it's a lot of folks. I don't
22 remember the exact number, but that sounds like a
23 conservative -- over a thousand people.

24 Q. And I think during your testimony you said you recall
25 having problems returning the stock on four or five

1 occasions?

2 A. Well, in what her specific reference was, yes.

3 Q. Do you recall occasions when Derivium did give the stock
4 back?

5 A. Yes.

6 Q. And of these thousand borrowers, I think you testified
7 that only a handful were sent to Bob Nagy?

8 A. I couldn't tell you how many, but it was not -- it was
9 not real common, but it was something, as I said, he was a
10 resource, you know, for if we thought that a client needed,
11 you know, that he could answer a question.

12 Q. And to your knowledge, was the tax advice on, that Mr.
13 Nagy gave in the letters, was that on the Derivium website?

14 A. Um, I'm sorry. Letters?

15 Q. Have you ever even seen Mr. Nagy's --

16 A. I've seen some things that, you know -- I'm sure this
17 might be a technical term that I shouldn't use, but he had,
18 like, an opinion or something that certain things -- certain
19 parts of the Tax Code were relevant, you know, he outlined
20 them in a paper.

21 I don't know if it was on, in fact, a letter that
22 you might send somebody that was written up because -- and
23 I'm assuming that it was so that a client could take them to
24 their own tax advisor and say, you want to look at these
25 areas of the Tax Code because they are applicable? And that

1 was how I understood it.

2 Q. This document that you saw, was it on the Derivium
3 website?

4 A. I probably would have seen a paper copy. I don't think
5 it was on the website, but I couldn't say for sure. We
6 didn't use the website that much in our office.

7 Q. And the database that you kept, did you enter into the
8 database when this borrower stock was received into the
9 brokerage account?

10 A. Yes.

11 Q. And did you enter into the database when the stock was
12 sold?

13 A. Yes.

14 Q. And did you keep meticulous records about when the stock
15 was sold and how much for?

16 A. Yes.

17 Q. And were these Derivium's books and records?

18 A. In -- yes.

19 Q. You were shown Exhibit -- Government Exhibit 317 about
20 who could view the bank accounts?

21 A. Yeah.

22 It's -- at the time -- and I'll just give you
23 background -- this is early when the banks are starting to
24 let you do online banking and funds transfers, and it was a
25 rather cumbersome process at the time, but we would

1 electronically transfer our -- the borrower's funds, you
2 know, to their account. We would transfer them to, you know,
3 lender's accounts, and so we had to set up a whole second set
4 of records just for the online, that's what the Wachovia
5 connection was called.

6 And so this was to put on one piece of paper who had
7 access and what they could do, so you know -- because
8 sometimes you needed someone to confirm a transfer or
9 initiate with several people in the office, you couldn't --
10 you would not want to have someone initiate the transfer and
11 then not have anybody in the office that could refer, so you
12 needed to know what their jobs were.

13 Q. Well, Mr. Nagy wasn't part of this e-mail, was he?

14 A. No.

15 Q. And he didn't have any of those duties or authorities you
16 just described?

17 A. No.

18 Q. And then Government's Exhibit 182 that they showed you,
19 that y'all talked about, the script?

20 A. Yes.

21 Q. Again, Mr. Nagy's not part of this e-mail?

22 A. No.

23 Q. He didn't have any input into the script, did he?

24 A. No.

25 Q. And these quarterly report statements that she showed you

1 in Exhibit 155, these were documents that you sent, or you or
2 Derivium sent to borrowers, correct?

3 A. Correct.

4 Q. And did Mr. Nagy cause you to send these documents out to
5 folks?

6 A. No.

7 Q. And you remember she refreshed your recollection with
8 this document about Mr. Nagy's input?

9 A. Yes.

10 Q. And again, like the year-end statement, wasn't your
11 understanding was that so borrowers could correctly report
12 any taxes?

13 MS. WEIS: Objection.

14 THE COURT: Sustained.

15 Q. Was -- from your work with Mr. Nagy, was your
16 understanding that his input was related to give borrowers
17 information related to taxes?

18 MS. WEIS: Objection.

19 THE COURT: Lay a foundation for it. I'll sustain
20 that.

21 Q. From the e-mail that you have, do you even recall talking
22 to Mr. Nagy about what his input was on this document?

23 MS. WEIS: Objection, 802, 801.

24 THE COURT: Overruled.

25 THE WITNESS: I'm sorry. Can you ask the question

1 again?

2 Q. Sure.

3 Can you even recall what Mr. Nagy's input was into
4 this document?

5 A. I do not remember, you know, specifically which lines he
6 might have had input into.

7 THE COURT: Okay. That's enough.

8 THE WITNESS: Okay.

9 THE COURT: You answered the question.

10 Q. Was the form of this document ultimately approved by Yuri
11 Debevc?

12 A. Um, or Dr. Cathcart, I don't remember.

13 Q. So Mr. Nagy did not give approval for this form of the
14 document?

15 A. Um --

16 MS. WEIS: Objection.

17 THE WITNESS: I don't recall if he would have given
18 the approval.

19 Q. What I'm trying to get at, it's in the hierarchy that Mr.
20 Nagy was not the ultimate decision maker?

21 A. That's correct.

22 THE COURT: Mr. Cooper, how close are you to being
23 done?

24 MR. COOPER: Um, if we could take a five-minute
25 break.

1 THE COURT: We don't take five-minute breaks after
2 6:00, we take ten-hour breaks after 6:00.

3 So how close are you to being done?

4 MR. COOPER: I believe I'm pretty close -- well --

5 THE COURT: I mean, are you going to have any
6 redirect, Ms. Weis?

7 MS. WEIS: Less than five minutes.

8 THE COURT: We'll start again at 9:30 in the
9 morning. She's the one that is really working hard here.

10 So can everybody be here at 9:30 rather than 10:00?
11 Yes? Except the witness?

12 THE WITNESS: I do some volunteer work for somebody.
13 They called a monthly meeting tomorrow at 8:30. I can be
14 here by 10. I'm sorry, Your Honor.

15 THE COURT: Okay. All right. So we'll start at
16 10:00 tomorrow morning.

17 MS. WEIS: Your Honor, we have some things we could
18 do.

19 THE COURT: We'll do things before y'all get here
20 and after y'all leave, too, all right?

21 So let's come back at 10:00 tomorrow morning, and
22 turn your notes upside down or take them in the jury room,
23 leave them there, whatever you want to do.

24 Don't discuss the case among yourselves, don't let
25 anyone discuss it with you, don't decide this case until

1 after you've heard all the evidence.

2 So we'll see y'all at 10:00 in the morning. Thank
3 you.

4 (Thereupon, the jury retired from the courtroom.)

5 THE COURT: Okay. We'll start again at 10:00 in the
6 morning. You need to be here at 9 or 9:30. I thought you
7 wanted to go over --

8 MS. WEIS: I was actually referring to we had some
9 deposition testimony, it will take less than an hour, but we
10 are not going to object to starting at 10.

11 THE COURT: How about -- do we need to discuss the
12 deposition? Okay. Why don't we show up here at 9:00 in the
13 morning. If we've got some arguments over the deposition, we
14 need to get those out of the way anyway. If we get done
15 before 9:30, we'll take a break.

16 Okay. We'll see y'all at 9.

17 (Thereupon, the court was in recess.)
18
19

20 *****

1 I certify that the foregoing is a correct transcript
2 from the record of proceedings in the above-titled matter.
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8 Amy C. Diaz, RPR, CRR

January 8, 2011

9
10 S/ Amy Diaz

11
12 Exhibit Numbers 11, 12, 20, 38, 40, 54, 116, 120, 19
13 142 and 143

14 MR. KENNETH POLK

77

15 DIRECT EXAMINATION

77

16 BY MR. SEADOR

17 Government Exhibit Number 235

87

18 Government Exhibit Number 236

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19 Government Exhibit Number 236

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20 Government Exhibit Number 235

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21 CROSS-EXAMINATION

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22 BY MR. COOPER

23 REDIRECT EXAMINATION

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24 BY MR. SEADOR

25 MR. LEROY EUGENE STRICKLAND, II

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